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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1969

No. 1483

THE CITY NATIONAL BANK OF FORT SMITH, ARKANSAS,
a National Banking Association,
Respondent,

v.

ILO VANDERBOOM (Appellant in No. 19,550), DeHAAN LIVESTOCK & GRAIN FARMS, INC., a South Dakota Corporation, ANDY D. DeHAAN, KENNETH J. DeHAAN and LYLE R. DeHAAN (Appellants in No. 19,551), H. T. RINGLING (Appellant in No. 19,552), JAMES NACHTIGAL (Appellant in No. 19,553), and ROBERT CARTER (Appellant in No. 19,554),
Petitioners.

PETITION FOR A WRIT OF CERTIORARI

To the United States Court of Appeals for the Eighth Circuit

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ILO VANDERBOOM (Appellant in No. 19,550), DeHAAN LIVESTOCK & GRAIN FARMS, INC., a South Dakota Corporation, ANDY D. DeHAAN, KENNETH J. DeHAAN and LYLE R. DeHAAN (Appellants in No. 19,551), H. T. RINGLING (Appellant in No. 19,552), JAMES NACHTIGAL (Appellant in No. 19,553), and ROBERT CARTER (Appellant in No. 19,554),
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Ilo Vanderboom, DeHaan Livestock & Grain Farms, Inc., a South Dakota corporation, Andy D. DeHaan, Kenneth J. DeHaan, and Lyle R. DeHaan, H. T. Ringling, James Nachtigal and Robert Carter, your petitioners, respectfully pray that a writ of certiorari be issued to review the judgment and opinion of the United States Court of Appeals for the Eighth Circuit entered in the above entitled causes, consolidated below, on February 20, 1970.

REPORTS OF OPINIONS BELOW

The opinion of the United States Court of Appeals for the Eighth Circuit by panel, was filed February 20, 1970, and it is not yet published in the Federal Reporter. The consolidated opinion is reproduced as Appendix A hereto. The consolidated judgment of the Court of Appeals dated February 20, 1970, is reproduced as Appendix B hereto.

The consolidated opinion on motion for summary judgment of the United States District Court for the Western District of Arkansas, Fort Smith Division, was filed on September 27, 1968, and is reported in 290 F. Supp. 592. The opinion is reproduced as Appendix C hereto. The judgments of the District Court, consolidated for appeal, were entered on October 2, 1968, and are reproduced as consolidated as Appendix D hereto.

GROUNDS ON JURISDICTION IS INVOKED

(i) The judgment of the United States Court of Appeals was dated and entered on February 20, 1970. See Appendix B.

(ii) A timely petition for re-hearing was denied March 20, 1970. See Appendix E. This petition for a writ of certiorari was filed within ninety (90) days of that date.

(iii) 28 U. S. C., Section 1254(1) confers on this Court jurisdiction to review the judgment of the United States Court of Appeals by writ of certiorari.

QUESTIONS PRESENTED FOR REVIEW

1. Whether the requirements of an SEC Rule 10 b-5 private action are more restrictive as to class of persons protected, class of persons obligated, and as to acts constituting a violation of the rule than the requirements of a common law fraud action?

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(a) **Class Protected:** Does a highly restrictive standard "reasonable investor" test [which conflicts with the rule of the Second Circuit in **Heit v. Weitzen**, 402 F. 2d 909, **cert. den.**, 395 U. S. 903 (1968)], applied to a private non-registered securities action under Rule 10 b-5 seriously impair the Congressional policy of broad anti-fraud protection stated in the Securities acts and recognized by this Court in **SEC v. National Securities**, 393 U. S. 453, 89 S. Ct. 564 (1968)?

(1) Should a private investor buying securities on the basis of direct personal misrepresentation and nondisclosure be held to a higher standard of investigation for reliance than a purchaser relying on publicly disseminated securities information?

(2) Are honest men whose word is their bond and who are accustomed to relying on the word of their banker outside the class of persons protected by Section 10(b) and SEC Rule 10 b-5?

(b) **Class Protected and Class Obligated:** Does a securities purchaser, who purchases in reliance upon material misrepresentations and nondisclosures of a third party to the transaction, but in an apparent position of inside knowledge, have a Rule 10 b-5 action against the third party?

2. May a Court, on appeal from a summary judgment dismissing a Rule 10 b-5 and a common law fraud action, create a "reasonable investor" test, and summarily decide in the very proceeding in which the test was created a factual question dispositive of both fraud counts without first remanding the case for full development of the facts relative to the test created without violating the right of the party opposing the motion for summary

judgment to a trial by jury reserved under the Seventh Amendment to the Constitution of the United States?

3. Should a federal court be permitted to dismiss with prejudice a jurisdictionally pendent common law securities fraud action against a third party tort feasor by the application of restrictive federal requirements regarding "standing to sue under Rule 10 b-5" and "statutory coverage of Section 10 (b)" where such federal requirements do not exist in common law fraud, and where the federal requirements are in conflict with controlling state law?

CONSTITUTIONAL PROVISIONS, STATUTES AND REGULATIONS INVOLVED

Constitution of the United States Seventh Amendment:

> "In suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved, and no fact tried by a jury shall be otherwise re-examined in any Court of the United States, than according to the rules of the common law."

Section 10 (b) of the Securities Exchange Act of 1934 (48 Stat. 891 (1934), 15 U. S. C., Section 78j (b) (1964)):

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .
>
> • • • • • • •
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

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SEC Rule 10b-5 (17 C. F. R., Section 240.10b-5 (1969):

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

"(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made in light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

in connection with the purchase or sale of any security."

STATEMENT OF THE CASE

In the fall of 1965 and in the early part of 1966, the petitioners, citizens of the small farming community of Platte, South Dakota, purchased Class B, non-voting stock directly from a new Arkansas corporation, Investors Thrift Corporation of Fort Smith, Arkansas (hereinafter called ITC). The total purchase price was $415,750.00, advanced in actual reliance upon the representations and conduct of officers of the City National Bank of Fort Smith, together with Sam Sexton, Jr., James Hall, Huey Smith, Austin Gatlin and Texas Capital Corporation officials. Those representations were to the effect that certain assets under contract of sale to ITC were very valuable businesses, and that petitioners would be making a good investment in ITC. Instrumentalities of interstate commerce were employed. The representations were false,

and the ITC stock was virtually worthless when the purchases were consummated.

After completion of an audit of these assets acquired by ITC with its capital raised from the South Dakota investors, the petitioners, together with nine (9) other South Dakota investors, initially instituted a law suit for relief from the fraud perpetrated on them in the state court of South Dakota against the City National Bank of Fort Smith, James Hall, Sam Sexton, Huey Smith and Austin Gatlin. However, the Bank obtained an injunction in the United States District Court for the Western District of Arkansas, based on federal venue statutes pertaining to national banks, against the maintenance of the South Dakota action against the Bank.

The Bank then instituted these five (5) consolidated civil actions in the United States District Court (Fort Smith Division) against the petitioners on the unpaid balance of promissory notes executed by the petitioners to obtain a substantial portion of the funds used to purchase the ITC stock. The petitioners counterclaimed alleging both SEC Rule 10b-5 securities fraud and common law fraud.

The basis for federal jurisdiction is (1) diversity of citizenship with a sufficient amount in controversy, and (2) Section 27 of the Securities Exchange Act of 1934, 15 U. S. C. 78aa.

The only security for the notes sued on by the Bank were pledges of the ITC stock purchased with the loan proceeds, which proceeds had been deposited by the Bank directly into the Bank's ITC account and disbursed to Hall, Sexton, Smith and Texas Capital Corporation by the Bank for ITC's purchase of the assets misrepresented.

The Bank moved for a default judgment, and to dismiss or strike the counterclaims filed. The motion was

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denied. The Bank moved for summary judgment on the pleadings. The motion was denied. The petitioners then sought to join the others involved in the stock transaction as third party defendants. This motion was also denied. Therefore, the petitioners and other investors filed a separate civil action against the Bank, James S. Hall (executive vice-president of the Bank at the time of the loans), Sam Sexton, Jr., a Fort Smith attorney, Huey Smith, Texas Capital Corporation, Austin Gatlin and Erma Gatlin, his wife, and Diamond G Ranch, Inc., a Gatlin-owned corporation. The petitioners and the other investors moved to consolidate the separate action with the instant cases for trial. The motion was denied.

The Bank then filed a second motion for summary judgment with supporting exhibits. The petitioners moved for leave to amend their counterclaims to allege in detail the transaction and the cause of action under Rule 10 b-5 of the Securities and Exchange Commission. The motion was granted and the amended counterclaims filed.

The petitioners responded to the motion for summary judgment with exhibits attached thereto. On September 27, 1968, the District Court filed its opinion sustaining the Bank's motion for summary judgment. On October 2, 1968, judgment was entered on the notes, and the counterclaims of the petitioners were dismissed with prejudice. The Court found no genuine issues as to material facts, no use of an instrumentality of interstate commerce, thereby dismissing the Rule 10 b-5 action, that no privity existed between the petitioners and the Bank in connection with the stock purchase, and that the petitioners had waived any fraud by extending the notes (the extension was for the stated purpose of awaiting the results of an audit of the assets purchased by ITC).

The petitioners timely appealed to the United States Court of Appeals for the Eighth Circuit. On February

20, 1970, by panel consisting of Judges Mehaffy, Gibson and Heaney, the Court of Appeals affirmed the District Court, but stated different grounds from those of the District Court.

In short, the Court of Appeals held that the petitioners had no "standing to sue under Rule 10 b-5" because they did not meet the "'purchaser-seller' standing requirement" imposed by the "in connection with the purchase or sale of any security" clause of both Section 10 (b) and SEC Rule 10 b-5, and suggested that the proper action would have been a stockholders' derivative suit on behalf of ITC. Further, the Court ruled that the "alleged misrepresentations and nondisclosures on the part of the Bank do not fall within the statutory coverage of the 'in connection with the purchase or sale of any security' clause." In so ruling, the Court of Appeals, in conflict with **Heit v. Weitzen,** 402 F. 2d 909 (2d Cir. 1968), cert. den., 395 U. S. 903 (1969), created an objective standard "reasonable investor" test applicable to (1) the standard of care that the investor must exercise before relying upon misrepresentations and nondisclosures, and (2) applicable to the question of whether the "defendant's misrepresentation or nondisclosure was made with scienter or from a lack of due diligence". In so doing, the Court of Appeals states that it is imposing a duty of reasonable investigation on the investor, "thereby limiting the class of investors who will be protected under Rule 10 b-5 (2) to conscientious buyers and sellers in good faith". The Court of Appeals did not mention the 10 b-5(1) and (3) aspects of these cases in its dispositive rulings.

The Court of Appeals stated that it was immaterial whether the petitioners in fact relied upon the misrepresentations and conduct of the Bank officials. Then, applying its test, the Court found that as to misrepresentations, no reasonable investor would believe the president of the

Bank; and that as to nondisclosures, that the Bank owed the petitioners no duty to make a full disclosure, even of information in its possession and knowledge.

The Court of Appeals then concluded that "since the petitioners are not entitled to recoup against the Bank for their unfortunate investments with Markham (president of ITC), and ITC under the more liberal and broader coverage of Rule 10 b-5, it is clear that they have not shown any basis for a common law fraud action under Arkansas law against the Bank". This conclusion, based on a general comparison of a federal question with the common law fraud question, without analyzing the elements of each count, and being dispositive of the common law fraud count, necessarily applies to Arkansas common law fraud the following:

(1) The purchaser-seller standing to sue requirement of Rule 10 b-5

(2) The objective standard reasonable investor test created by the Court of Appeals in the process of construing the federal question, and denies to petitioners:

(a) The Arkansas law on constructive fraud permitting recovery against third party tort feasors for innocent misrepresentations of material facts.

(b) The absolute right under Arkansas law of a purchaser to rely upon a material misrepresentation of one having apparent peculiar knowledge of the facts as here, though the means of ascertaining its falsity were fully open to the purchaser, and

(c) A procedural and substantive safeguard surrounding the application of summary judgment procedure on common law fact questions, and the right to trial by jury on disputed fact questions

preserved by the Seventh Amendment to the Constitution of the United States.

The petitioners timely filed a petition for re-hearing, which was denied on March 20, 1970. This petition for writ of certiorari seeks to review the judgment of the Court of Appeals, and its effect on this and the related case of all of the investors and ITC against Sexton, Hall, Smith, Gatlin, Diamond G Ranch, Inc., and Texas Capital Corporation. The related case was reversed in part by the United States Court of Appeals and remanded for trial. A petition for writ of certiorari in the related case is also being prepared for filing in this Supreme Court on the individual standing to sue question, and on a limitation of actions question based on conflict with other United States Courts of Appeal.

REASONS FOR GRANTING THE WRIT

Class Protected—Reasonable Investor Test

Pursuant to authority contained in Section 10 (b) of the Securities Exchange Act of 1934, the Commission adopted Rule 10 b-5 proscribing the conduct of any person, directly or indirectly, through the use of any means or instrumentality of interstate commerce (1) to employ any device, scheme or artifice to defraud, (2) to make any untrue statement of a material fact, or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (3) to engage in any act, practice or course of conduct which operates or would operate as a fraud or deceit upon any person, all in connection with the purchase or sale of any security. In short, the rule is violated by any person, directly or indirectly, who defrauds any person or makes a material misrepresentation or half-truth to any person in connection

with the purchase or sale of any security in interstate commerce.

Except for the requirement of jurisdictional means (the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national security exchange), it does not appear that the statute or the rule has added anything to the elements of common law fraud. Rather, the broad language prohibiting "any person, directly or indirectly", from committing the proscribed acts upon any other person "in connection with the purchase or sale of any security" manifests an intent to liberalize the restrictive elements of common law fraud, at least to the extent that the restrictive elements of common law fraud are already liberalized by the concept of legal or constructive fraud prevailing in the majority of jurisdictions throughout the United States. See 37 Am. Jur. 2d, Fraud and Deceit, Section 4, and cases cited including **Lane v. Rachel**, 239 Ark. 400, 389 S. W. 2d 621 (1965), and 37 C. J. S., Fraud, Section 2, page 211.

In construing Section 10 (b) of the 1934 Act, the Court of Appeals in this case established the following statutory coverage test:

> "(1) With regard to misrepresentation, the question is whether a reasonable investor, in light of the facts existing at the time of the misrepresentation and in the exercise of due care, would have been entitled to rely upon the misrepresentation. With regard to nondisclosure, the issue becomes whether a reasonable investor, in the light of the facts existing at the time of the nondisclosure and in the exercise of due care, would have been entitled to receive full disclosure from the party charged and would have acted differently had the alleged nondisclosure not occurred.
>
> (2) If the plaintiff satisfied this 'in connection with' step, it then becomes necessary to determine whether

the defendant's misrepresentation or nondisclosure was made with scienter or from lack of due diligence."

The Court of Appeals below then stated that:

"It should be noted from the outset that this 'reasonable investor' test is an objective standard. Whether an investor did in fact rely upon a misrepresentation is immaterial for the purpose of determining the statutory coverage, though reliance is a predicate for recovery once coverage is established. In applying this test to the instant case, we find a reasonable investor would not have relied on any representations made by Smoot [president of the Bank] and that the Bank did not owe a duty of full disclosure to any of the investors."

The Court below is saying that it matters not that the interstate commerce jurisdictional means exists, that an individual purchased a security from a corporate issuer, or that the plaintiff in fact relied upon the false representations of a third person as to property under contract of sale to the corporate issuer, and its sole asset. The Court below requires more, expanding the "statutory coverage of the 'in connection with' the purchase or sale of any security" clause to also require the injured party to meet a "reasonable investor" test, which is made an objective standard and decided by the Court as a jury in the first appellate case in which such objective standard is created and enunciated. And this for the express purpose of "limiting the class of investors who will be protected under Rule 10 b-5(2) to conscientious buyers and sellers in good faith." In its rulings and application of the test, the Court of Appeals disregarded the existence of the 10 b-5(1) and 10 b-5(3) aspects of the case. The effect of the objective standard and the requirement of more than actual reliance is to eliminate from the pro-

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tected class of securities investors, those who in fact relied upon the fraudulent acts or schemes of parties inducing, directly or indirectly, a securities transaction in interstate commerce—one who acted on the representations of men of apparent knowledge and integrity—persons who are accustomed to dealing with men whose word is their bond, and, who therefore, are not conscientious according to an objective standard to be decided by the court without a jury.

There is a vast difference between the word "conscientious" and the word "good faith". The addition of the word "conscientious" raises a new judicial thicket in the developing law on Rule 10 b-5 actions. The word poses such questions as: "How much money and time should an investor be required to spend in the investigation of a representation made by one who is in an apparently peculiar position of knowledge? Is the same degree of investigation required by an investor relying upon publicly disseminated information as that required of an investor meeting face to face with the parties involved in the transaction? Does the investor have no right of reliance on a representation when he could have learned of the falsity by expending unlimited funds and energies discovering the truth? Is the investor required to conduct an extensive investigation when the misrepresented facts are being deliberately concealed from him? Have we returned to the rule of *caveat emptor*?"

The Court below also says that the Bank had no duty of full disclosure as a matter of law. This holding was made in the face of the overt misrepresentation of the Bank and the injunctional clause (2) of Rule 10 b-5 against half-truths. This holding of the Court below raises numerous additional problems in the securities fraud field. The natural question is, "When would such a duty arise?"

Is the answer to be, "At a time when a bank is a fraudulent issuer of bank stock? At a time when the bank knowingly misrepresents the value of securities held as an asset by it? At a time when the bank knowingly misrepresents the value of securities held by one of its officers for the purpose of protecting the financial security of that officer, or would the duty of disclosure arise when as at common law, a person having apparent knowledge, the primary banking connection of a business and in possession of its financial statements, is asked to express an opinion as to the soundness of the business, and does it wrongfully?" If not, the public had best be warned not to inquire or rely on the representations and actions of their banker on an investment matter about which the banker has apparent peculiar knowledge, and expresses when asked that he knows the investment is sound. The public in all fairness should be advised by this Court that bankers possess special privileges of nondisclosure on inquiry and special privileges to misrepresent facts that other corporate officers do not have, if such is the law of the land.

The Court below has said in this case that a banker in a static role, without access, is not charged with the knowledge in his financial institution's files, but that the non-voting, non-office holding investors, through their corporate issuer's president, new in his role, and admittedly not experienced financially, who was busy soliciting funds to complete the corporate contract of purchase, but also with legal access, is charged with the knowledge of facts in his financial institution's files, which could only be revealed and which were in fact, especially on summary judgment, only revealed after bookkeeping adjustments, investigation and audit covering a period of many months and costing several thousand dollars. If such is the burden of an investor under Rule 10 b-5 to satisfy the requirements of being conscientious and in good faith, then few,

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if any, investors will ever succeed in a private personal contact 10 b-5 action again.

The application of step (1) of the "reasonable investor" test established by the Court of Appeals below imposes a greater requirement upon an injured party than the requirements of common law fraud and deceit, and far greater requirements than those required in a constructive fraud action where an innocent misrepresentation is enough.

Even under Arkansas common law, a purchaser is absolutely entitled to rely upon a material representation of one having apparent peculiar knowledge of the facts. As stated by the Supreme Court of Arkansas in **Maurice v. Chaffin**, 219 Ark. 273, 214 S. W. 2d 257 (1951), in rescinding a truck sale fraud:

> "When the representation is made of a fact that has nothing to do with opinion, and it is peculiarly within the knowledge of the person making it, the one receiving it has the absolute right to rely upon its truthfulness though the means of ascertaining its falsity were fully open to him. Evatt v. Hudson, 97 Ark. 265, 133 S. W. 1023, 1025, and the very recent case of Fausett & Co., Inc. v. Bullard, 217 Ark. 176, 229 S. W. 2d 490, 491. Representations are considered fraudulent if made by one who either knows them to be false or else, not knowing, asserts them to be true."

Under Arkansas law, it is only necessary that the purchaser rely upon the false representation, if in fact he does not rely upon his own investigation. **Fausett & Co., Inc. v. Bullard**, supra, and Rest. Torts, Section 547. A stranger to the transaction with nothing to gain, but with apparent knowledge of the facts, is far more credible to an innocent purchaser than a seller who is also a stranger. Yet in a 10 b-5 action, no reliance is permitted a good faith pur-

chaser, who is not conscientious in his investigation of the truth or falsity of a representation made.

The "reasonable investor" test made objective, by the Court of Appeals below conflicts with the ruling of the Second Circuit Court of Appeals in the case of **Securities and Exchange Commission v. Texas Gulf Sulphur Co.**, 401 F. 2d 833 (2d Cir. 1968) (in banc) **cert. denied**, 394 U. S. 976 (1969), which construed the "in connection with" requirement broadly and held that "Rule 10 b-5 is violated whenever assertions are made, as here, in a manner reasonably calculated to influence the investing public, e. g., by means of the financial media, . . . if such assertions are false or misleading or so incomplete as to mislead irrespective of whether the issuance of the release was motivated by corporate officials for ulterior purposes." The Second Circuit Court of Appeals in the Texas Gulf Sulphur case, supra, reasoned:

> ". . . it seems clear from the legislative purpose Congress expressed in the Act, and the legislative history of Section 10 (b), that Congress when it used the phrase 'in connection with the purchase or sale of any security' intended only that the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, caused them to purchase or sell a corporation's securities. There is no indication that Congress intended that the corporations or persons responsible for the issuance of the misleading statement would not violate the section unless they engaged in related securities transactions or otherwise acted with wrongful motives; indeed, the obvious purposes of the act to protect the investing public and to secure fair dealing in the securities market would be seriously undermined by applying such a gloss onto the legislative language."

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While the rule of the Court of Appeals in this case appears similar, it must be remembered that the **Texas Gulf Sulphur** rule was enunciated (but not applied) in a case involving public release of information affecting the market value of securities traded on a national securities exchange. The rule in the case at bar is enunciated and applied to a private non-registered security transaction, where the misrepresentations and allegedly illegal conduct occurred on a face to face basis. But of most substantial significance is the fact that the Second Circuit in the **Texas Gulf Sulphur** case concluded that it did not have sufficient facts before it upon which to apply its rules, and it did not decide the test objectively. That Court remanded the issue to the District Court, which took the testimony and heard and saw the witnesses for a determination of the character of the release in the light of the facts existing at the time of the release. The **Texas Gulf Sulphur** case was tried at length before Judge Bonsal of the Southern District of New York, **sitting without a jury** (401 F. 2d at 842). The case at bar has not been tried!

The Second Circuit Court of Appeals in **Heit v. Weitzen**, supra, made clear that the first step of the statutory coverage test is governed by the principles enunciated in **Texas Gulf Sulphur**, supra.[1]

The objective application of the restrictive "reasonable investor" test created by the Court of Appeals below stands in clear conflict with the purpose of the federal statutes regulating the sale of securities liberally construed by this Court in **Securities and Exchange Commis-**

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[1] See Annot., 3 A. L. R. Fed. 819: Fraud or deceit as "in connection with" purchase or sale of securities within the meaning of the Securities Exchange Act of 1934, Section 10 (b) (15 U. S. C., Section 78 j(b)) and SEC Rule 10 b-5; and Annot., 37 A. L. R. 2d 649: Civil action by private person under Section 10 (b) of the Securities Exchange Act of 1934 (15 U. S. C. 78 j (b).

sion v. C. M. Joiner Leasing Corporation, 320 U. S. 344, 64 S. Ct. 120 (1943), and the test emasculates the Congressional policy of broad anti-fraud protection enunciated in the Securities Acts and recognized by this Court in **SEC v. National Securities**, supra.

As applied to the facts of this case, to say the least, the test adopted by the Court of Appeals below permits innocent non-sophisticated investors to become victims of fraud perpetrated by sophisticated con artists, lawyers, and bank officers through the use of corporate shields, and by exempting knowledgeable third parties from liability for at least negligent misrepresentations and omissions. Here a man in the high position of bank president, obviously in possession of inside knowledge regarding the soundness of assets upon which the entire value of the security being purchased depended, is exonerated under the test.

In view of the apparent fact that holding companies, corporate conglomerates, and corporate acquisitions are the fashion of the day, the holding of the Court of Appeals constitutes an invitation and a license to perpetrate securities fraud through the use of third parties for the purpose of unloading sick securities contrary to the Congressional purpose of investor protection in enacting the Securities Acts in the face of the broad remedial and protective purpose of the acts. The harm is especially evident when third party bankers, who are the principal banking connection of the sick corporation in possession of all its corporate financial statements, are permitted in recommending the sick stock, as here, to hide behind the strict duty of investigation imposed upon the prospective purchaser. The harm is further compounded when the third party is permitted to hide behind the protection afforded here of no duty to disclose the whole truth after once making a representation requiring a clarification under

the circumstances in which made in order not to mislead the prospective purchaser. The conduct is clearly proscribed by the plain language of Rule 10 b-5. And the ruling of the Court below is even more onerous in treating Rule 10 b-5 as Clause (2) only, when concealment of a material fact in furtherance of a clear scheme to defraud in violation of Clauses (1) and (3) exists in the record on summary judgment.

Class Protected and Class Obligated

Additional Factual Background: The petitioners state and the record clearly reflects on summary judgment that the petitioners purchased Class B, non-voting stock issued by ITC, an Arkansas corporation, through the use of instrumentalities of interstate commerce and through their dealings with the City National Bank in actual reliance upon the Bank officials' misrepresentations and concealment of material facts. The representations of the Bank concerned the value of the assets being purchased by ITC, the corporate issuer to the petitioners, at a time when ITC had no other asset. The business assets being acquired by ITC were incorporated also. It later developed that the ITC stock because of the worthlessness of its assets was also worthless at the time of purchase.

At the time of the petitioners' loans from the Bank and the Bank's misrepresentations and concealments, the announced purpose of ITC, known to the Bank, was to use the funds borrowed to buy the assets misrepresented. The Bank encouraged the consummation of this purchase in lending substantial sums (the largest loans of a lifetime to most), secured only by a pledge of the ITC stock, without an apparent detailed inquiry into the financial stability of the petitioners, and by overtly misrepresenting the assets being acquired by ITC as good investments, and by concealing the additional personal interest of

Mr. Hall that the entire transaction be consummated, so that Hall would be relieved of a guarantee of a substantial loan to Texas Capital Corporation. Immediately preceding the first loans made, Mr. Smoot, president of the Bank, sat silently by while Mr. Hall, executive vice-president of the Bank and one of the asset sellers, further misrepresented the assets being acquired by ITC as highly profitable and sound business. The South Dakota petitioners were accustomed to relying upon the word of their bankers, and did so here. In some cases, they limiting their stock investments to the amount of the loans authorized by the Bank.

Privity Requirement: On summary judgment, the Court of Appeals conceded that the Bank officials lending money to the petitioners misrepresented and concealed material facts about the assets being purchased by ITC. But because the assets misrepresented were being purchased by ITC, the stock seller to the petitioners, and because the Bank did not sell securities to the petitioners, the Court below held that the purchasers did not meet the "purchaser-seller" requirement of the "in connection with the purchase or sale of any security" clause of both Section 10 (b) of the Securities Exchange Act of 1934 and SEC Rule 10 b-5.

This holding poses the very real and substantial questions of what class of persons are protected and what class of persons are obligated to securities investors (purchaser-seller) for the violations of Rule 10 b-5 and Section 10 (b) of the 1934 Act.

It is clear that the Court of Appeals in this case has limited the class of persons protected to direct purchasers and sellers, relieving third parties committing acts amounting to common law fraud from liability under Section 10 (b) of the Act and the Rule.

While the Court below suggests that the petitioners should have brought a stockholders' derivative action on behalf of ITC against the Bank, ITC did not borrow funds from the Bank and did not receive nor act upon the misrepresentations and concealment of material facts by the Bank officials, other than Mr. Hall, an asset seller to ITC.

The total effect of the first holding of the Court of Appeals in this case is to require privity between the securities purchaser and the person, either directly or indirectly, violating Rule 10 b-5. This requirement of privity is contrary to the decisions in the Second, Sixth, and Ninth Circuit Courts of Appeal, holding that the liability of persons participating in securities fraud, and their aiders and abettors in violation of Rule 10 b-5 is not dependent on privity of contract. **Brown v. Bullock**, 194 F. Supp. 207, 229 (S. D. N. Y. 1961) aff'd. without discussion of this point, 294 F. 2d 415 (2d Cir. 1961); **Texas Continental Life Insurance Co. v. Dunne**, 307 F. 2d 242 (6th Cir. 1960), rev'g. 187 F. Supp. 14 (W. D. Ky.); **Errion v. Connell**, 236 F. 2d 447 (9th Cir. 1956).[2]

As stated in Gadsby, Business Organizations, Federal Securities Exchange Act of 1934, Vol. 11A, at pages 5-54:

> "The coup de grace to the privity requirement, however, seems to have been given in the Texas Continental case (Texas Continental Life Insurance Co. v. Dunne, 307 F. 2d 242 (6th Cir. 1960), rev'g. 187 F.

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[2] See also **Thiele v. Shields**, 131 F. Supp. 416 (S. D. N. Y. 1955); **Pettit v. American Stock Exchange**, 217 F. Supp. 21 (S. D. N. Y. 1963); **H. L. Green v. Childree**, 185 F. Supp. 95 (S. D. N. Y. 1960); **Miller v. Bargain City U. S. A., Inc.**, 229 F. Supp. 33 (E. D. Pa. 1964); **Brenan v. Midwestern United Life Insurance Co.**, 259 F. Supp. 673 (N. D. Ind. 1966); **Bredehaft v. Cornell**, 260 F. Supp. 557 (D. Ore. 1966); comment: Civil liability under a Section 10 (b) and Rule 10 b-5; a suggestion for replacing the doctrine of privity, 74 Yale L. J. 658, 661-667 (1965).

Supp. 14 (W. D. Ky.). This proceeding resulted from a rather lurid fraud, the plaintiff having bought its bonds from the notorious Ben Jack Cage, late of Texas, who in turn had bought the issue from the defendant in an ingenious but hardly commendable transaction involving a worthless note. There most certainly was no privity—of contract or otherwise—between the plaintiff and the underwriter which it was suing, and the Sixth Circuit court flatly announced that there was no such requirement.

It remained for Judge Herlands to sum up the situation, though in a different context, in Brown v. Bullock:

> 'Privity of contract between the plaintiffs and the defendants is not a fixed condition precedent to the implication of a private remedy for a statutory violation that injured the plaintiffs, members of the protected class. In that situation, privity is not an ultimate or operative fact. It is an evidentiary fact to be considered in conjunction with other material facts in determining whether the relationship (such as it is) between the plaintiffs and the defendants and the nature of the particular acts and transactions involve the duty created by the statute' (Brown v. Bullock, 194 F. Supp. 207, 229 (S. D. N. Y. 1961), aff'd. without discussion of this point, 294 F. 2d 415 (2d Cir. 1961))".

The resolution of this privity or "standing to sue" requirement is essential to effective enforcement of the Securities Exchange Act of 1934, and Rule 10 b-5 promulgated thereunder. If persons may defraud a securities purchaser by doing so through the medium of an innocent corporate issuer without violating Rule 10 b-5, then the courts have opened wide again the doors to uncontrolled stock fraud in interstate commerce. And such is not the Congressional intent announced in the Securities Acts. It

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is not difficult to imagine, it is even common, that in "con games" the guilty party will beguile one innocent party into soliciting others to invest with the first one duped, and the "con man" walks off with all the funds.

If privity is required between the protected class and the obligated class, then all any stock fraud artist need do to avoid 10 b-5 is first entice on a local face to face basis an innocent corporation into voting a public issue based upon representations as to assets to be sold to the issuing corporation by the third person. True, the corporation may have a separate cause of action for common law fraud, if it can prove the requisite elements including reliance and scienter, or circumstances justifying application of constructive fraud. But the 10 b-5 action of the individual stock purchaser in interstate commerce, purchasing in reliance upon the fraudulent representations, scheme and conduct of the third person is lost because they have no standing to sue the ones who defrauded them personally.

It matters not that the asset being purchased by the corporation is a race horse with a fractured leg, a purported rare painting which is a forgery, or shares of stock in a going enterprise falsely represented to be of great value, the effect is the same in any case, a direct or indirect, if you will, fraud against the stock purchasers.

Neither does it matter that one shareholder first bought stock on one day without fraudulent inducement, if he subsequently bought additional stock based on fraudulent inducement, contrary to Rule 10 b-5. The action should remain as his, and not merge with a corporate action which may be different and ineffectual. It is submitted that Congressional intent enunciated in the Securities Acts and in the better reasoned cases in the other Circuit Courts of Appeal justify the elimination of privity as a

requirement in Rule 10 b-5 actions. If the fraud and misrepresentations of the stock sellers, and their aiders and abettors can be avoided by the injection of a separate corporate structure, and the direction of the misrepresentations to non-voting, non-office holding investors in the intermediary corporate structure, the preventative and remedial effects of the 10 b-5 cases on securities fraud may be destroyed.

A Substantial Departure From Accepted Course of Judicial Proceedings

May a Court on appeal from a summary judgment dismissing a Rule 10(b)-5 and a common law fraud action, create a "reasonable investor" test, and summarily decide in the very proceeding in which the test was created a factual question dispositive of both fraud counts without first remanding the case for full development of the facts relative to the test created without violating the right of the party opposing the motion for summary judgment to a trial by jury reserved under the Seventh Amendment to the Constitution of the United States?

The question includes the facts pertinent to the issue and the reason for granting the Writ.

Rule 56, Federal Rules of Civil Procedure, authorizes summary judgment only where the moving party is entitled to judgment as a matter of law, where it is quite clear what the truth is, and where no genuine issue remains for trial. The purpose of the rule is not to cut litigants off from their right to trial by jury if they really have issues to try. **Poller v. Columbia Broadcasting System,** 358 U. S. 464, 825 S. Ct. 486 (1962).

Where several possible inferences can be drawn from the facts contained in the affidavits, attached exhibits,

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pleadings, depositions, answers to interrogatories, and admissions on file "[o]n summary judgment the inferences to be drawn from the underlying facts contained in such materials must be viewed in the light most favorable to the party opposing the motion." **United States v. Diebold, Inc.**, 369 U. S. 654, 655 (1962).

If the courts on appeal are permitted to create and summarily apply tests dispositive of a fact dispute without first giving the parties an opportunity to present what the parties consider to be facts material to the test created, the adversary system of justice will be seriously impaired. The issue of reasonable investigation by the petitioners of the representations made by the bank was not considered by the petitioners, nor their counsel, in responding to the motion for summary judgment below. The costs, the time required and the difficulty of actually ascertaining the truth or falsity of the representations made were available, and would appear to bear directly upon the question of whether the petitioners, or either of them, were conscientious when they in fact relied upon the representations of the bank officials.

The comparative application of the federal test to the common law fraud count concluding that the common law fraud count is included within the requirements of a 10 b-5 action, has the direct effect of denying to the petitioners the right to a trial by jury upon the fact issue of actual reliance on reasonable grounds, such action is contrary to the right of trial by jury on common law fact questions reserved under the Seventh Amendment to the Constitution of the United States.

The action of the Court of Appeals in denying this right so departs from the accepted and usual course of judicial proceedings as to justify the exercise of this Court's power of supervision by Writ of Certiorari.

Federal Court Decision in Conflict With Controlling State Law

Should a Federal Court be permitted to dismiss with prejudice a jurisdictionally pendent common law securities fraud action against a third party tortfeasor by the application of restrictive federal requirements regarding "standing to sue under Rule 10 b-5" and "statutory coverage of Section 10(b)" where such federal requirements do not exist in common law fraud, and where the federal requirements are in conflict with controlling state law?

At the conclusion of its opinion holding that the petitioners have no Rule 10 b-5 action, the Court of Appeals below stated:

> "Since the defendant investors are not entitled to recoup against the bank for their unfortunate investments with Markham (the president of ITC) and ITC under the more liberal and broader coverage of Rule 10 b-5, it is clear that they have not shown any basis for a common law fraud action under Arkansas law against the plaintiff bank."

As previously discussed, the 10 b-5 action was dismissed because of (1) lack of standing to sue under the purchaser-seller requirements of Rule 10 b-5 and (2) failure of the petitioners to meet the investigative requirements for reliance on misrepresentations of the bank under the first step of the "reasonable investor" test and (3) because the bank did not owe a duty of full disclosure to the investors under the second sentence of the first step of the "reasonable investor" test created by the Court in this very case.

Thus, it is clear that the common law fraud aspects of the case were not reached on their merits. It is further clear that the "standing to sue requirement of Rule 10

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b-5" and the "statutory coverage requirement of Section 10(b)" of the 1934 Securities and Exchange Act are not requisite elements of common law actual or constructive fraud actions anywhere in the United States!

Further, the application of the test does violence to the protection afforded investors by the availability of common law fraud actions requiring a lesser degree of reliance than that imposed by the test created here.

In defining actual fraud, the Arkansas Supreme Court in **Welch v. Farber**, 188 Ark. 693, 67 S. W. (2d) 588 (1934), stated:

> "In order to establish actionable fraud, the representations must be of a decided and reliable character which are calculated to mislead the purchaser and induce him to buy on the faith and confidence of the same. The false statement must be of an existing fact known by the one who makes such statement to be false, or, where he does not know, asserts it to be true with the intent to have the party to whom it is made act upon it to his injury. Such must be the effect on the party to whom the statement is made."

In much later cases, the Arkansas Supreme Court has stated that a purchaser is absolutely entitled to rely upon a material representation of one having apparent peculiar knowledge of the facts. As stated by the Supreme Court of Arkansas in **Maurice v. Chaffin**, 219 Ark. 273, 241 S. W. (2d) 257 (1951), in rescinding a truck sale as a fraud:

> " 'When the representation is made of a fact that has nothing to do with opinion, and it is peculiarly within the knowledge of the person making it, the one receiving it has the absolute right to rely upon its truthfulness though the means of ascertaining its

falsity were fully open to him.' Evatt v. Hudson, 97 Ark. 265, 133 S. W. 1023, 1025, and the very recent case of Fausett & Co., Inc. v. Bullard, 217 Ark. 176, 229 S. W. 2d 490, 491: 'Representations are considered to be fraudulent if made by one who "either knows them to be false or else, not knowing asserts them to be true."'"

Under Arkansas law, it is only necessary that the purchaser rely upon a false statement, and not a partial investigation. **Fausett & Co., Inc. v. Bullard,** supra, and Res. Torts, Section 547. And a stranger to the transaction with nothing to gain, but with apparent knowledge of the facts, is far more creditable to an innocent purchaser than a seller who is also a stranger. See 37 Am. Jur. 2d, Fraud and Deceit, Section 117. Reliance is to be presumed when the misrepresentation goes to a material matter. **Manhattan Credit Co. v. Burns,** 230 Ark. 418, 323 S. W. 2d 206 (1959).

Neither does the Arkansas law require privity between the parties for the maintenance of common law fraud. **Westinghouse Credit Corp. v. First National Bank of Green Forrest,** 407 S. W. 2d 388, 241 Ark. 287 (1966).

Arkansas has adopted the rule that "neither actual dishonesty of purpose nor attempt to deceive" is an essential element of constructive fraud, permitting recovery on innocent misrepresentations of material fact. **Lane v. Rachel,** 239 Ark. 400, 389 S. W. (2d) 621 (1965), **Kersh Lake Drainage District v. Johnson,** 203 Ark. 315, 157 S. W. (2d) 39 (1941), Fausett & Co. Inc. v. Bullard, 217 Ark. 176, 229 S. W. (2d) 490 (1950). In the latter case the Supreme Court of Arkansas also held that "it is not enough to relieve the maker of a fraudulent representation from liability that the person to whom it is made makes an investigation of its truth. It is necessary that the

other rely upon his investigation and shall not rely upon the false statement." Rest., Torts, Section 547.

It is clear from the foregoing that the United States Court of Appeals below has decided an important question bearing upon the availability of common law fraud to securities purchasers and sellers contrary to the controlling decisions of applicable state law. Further, the litigation of the South Dakota investors is split into three separate actions. The action of one investor against this Bank respondent is now on appeal to and under consideration by the Supreme Court of the State of Arkansas upon the question of whether the bank's conduct constitutes actionable common law fraud.

Even if no Rule 10 b-5 action exists because of the objective standard reasonable investor test, a test definitely not existing in the Arkansas actual or constructive fraud doctrine, the common law action should be reinstated and returned for appropriate proceedings in Fort Smith under the supervisory power of this court.

CONCLUSION

The Fifth Circuit Court of Appeals has aptly stated in the case of **Hooper v. Mountain States Securities Corp.**, 282 F. 2d 195, 201 (5th Cir. 1960), **cert. denied** 365 U. S. 814 (1961):

> "(10 b-5) greatly expands the protection frequently so hemmed in by the traditional concepts of common law misrepresentation and deceit—the requirements of privity, proof of specific damage, inadequacy of the right of rescission, the right to recover up to par value of stock of a much greater value. To these difficulties [obviated by Rule 10 b-5] would have to be added the greater obstacles of suit in a common

law form against multi-state defendants scattered as far as the fraudulent device required."

This Court, in dealing with the meaning of the same language as clauses (1) and (3) of SEC Rule 10 b-5 contained in the Investment Advisors Act No. 206, 50 U. S. C. A. 80 b-6, which lacks clause (2) of Rule 10 b-5, and treating that clause (2) as surplusage, commented on the developing relaxation of the common law, and concluded that even if Congress intended to codify the common law, it did so "remedially" not "technically." **SEC v. Capital Gains Research Bureau, Inc.**, 375 U. S. 180, 193-195 (1963). That decision refers to equity's version of fraud, which is broader than common law's and requires no evil intent:

> "Fraud, indeed, in the sense of a court of equity properly includes all acts, omissions and concealments which involve a breach of legal or equitable duty, trust, or confidence, justly reposed, and are injurious to another, or by which an undue and unconscientious advantage is taken of another." 375 U. S. at 194.
> ". . . it is the duty of the courts to be alert to provide such remedies as are necessary to make effective the Congressional purpose." J. I. Case Co. v. Borak, 377 U. S. 426, page 428 (1964).

The summary application of the strict "reasonable investor" test to both the SEC Rule 10 b-5 count and the common law fraud count is contrary to the duty enunciated above by this Court.

The rulings of the Court of Appeals in this case seriously conflict with the rulings of the Second, Sixth and Ninth Circuit Courts of Appeal on the issues presented. The opinion below decides an important state question in direct conflict with controlling state law, and does so by departing from the accepted and usual course of ju-

dicial proceedings to such an extent as to call for an exercise of this Court's power of supervision.

The creation and objective application of the "reasonable investor" test to private securities transactions based on personal, direct misrepresentations, as contrasted with transactions made in the open market in reliance upon publicly disseminated information, substantially destroys the remedial effect of Section 10 (b) and rule 10 b-5 on private transactions. This court should resolve these important questions raging in litigation about the country.

Respectfully submitted

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APPENDIX.

APPENDIX

APPENDIX "A"

Nos, 19,550, 19,551, 19,552, 19,553, 19,554

United States Court of Appeals
For the Eighth Circuit

(Caption Omitted)

Decided February 20, 1970

Before: Mehaffy, Gibson and Heaney, Circuit Judges

The appellants, a group of investors from South Dakota, sought in the District Court to recover on individual counterclaims, hereinafter referred to as counterclaim, predicated on alleged fraudulent misrepresentations in the sale of corporate stock. The appellee's claims on bank loans were admitted. Appellants allege both common law fraud and fraud proscribed by Section 10(b) of the Securities Exchange Act of 1934[1] and Rule 10b-5 of the Securities and Exchange Commission.[2] The Honorable John E.

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[1] 48 Stat. 891 (1934), 15 U. S. C., § 78j(b) (1964):

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

[2] 17 C. F. R., § 240.10b-5 (1969):

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange.

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements

Miller, Senior Judge, rendered summary judgment against appellants in an extensive and scholarly opinion reported in 290 F. Supp. 592 (W. D. Ark. 1968).

In reviewing the trial court's grant of the bank's summary judgment motion our function is to determine whether a genuine issue of material fact exists and, if no such issue exists, whether on the substantive law the movant is entitled to judgment. Fed. R. Civ. P. 56. Where several possible inferences can be drawn from the facts contained in the affidavits, attached exhibits, pleadings, depositions, answers to interrogatories, and admissions on file, "[o]n summary judgment the inferences to be drawn from the underlying facts contained in such materials must be viewed in the light most favorable to the party opposing the motion." *United States v. Diebold, Inc.*, 369 U. S. 654, 655 (1962). This court recognizes that summary judgment is an extreme remedy and that it should not be entered except where the movant is entitled to its allowance beyond all doubt. *Traylor v. Black, Sivalls & Bryson, Inc.*, 189 F. 2d 213, 216 (8th Cir. 1951). The basic test was articulated by the Supreme Court in *Poller v. Columbia Broadcasting System*, 368 U. S. 464, 467 (1962):

> "Summary judgment should be entered only when the pleadings, depositions, affidavits, and admissions filed in the case 'show that [except as to the amount of damages] there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law.' Rule 56(c), Fed. Rules Civ. Proc. This rule authorizes summary judgment 'only where the moving party is entitled to judgment

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made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

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as a matter of law, where it is quite clear what the truth is, . . . [and where] no genuine issue remains for trial . . . [for] the purpose of the rule is not to cut litigants off from their right of trial by jury if they really have issues to try.' *Sartor v. Arkansas Natural Gas Corp.*, 321 U. S. 620, 627 (1944)."

The intricate factual situation of this case is set forth in Judge Miller's reported opinion and will not be repeated in full here. However, for purposes of convenience in discussing the issues it is necessary to summarize the background and the dispositive facts.

Maurice Markham and his brother-in-law Jimmy Willis entered the shell home business in Oklahoma in 1960 by forming Markham Homes, Inc. In 1965 Markham Homes was in need of shell home financing and Markham contacted Austin Gatlin of Mountainburg, Arkansas to assist him in this quest. Gatlin, who formerly owned a majority interest in Peoples Loan and Investment Company, an Arkansas corporation, advised setting up a similar financial institution in Arkansas. To secure the capital required to materialize this idea, Markham solicited the help of the defendants in this action, who were friends and acquaintances made by Markham during the years he practiced veterinary medicine in South Dakota (up to 1962). The South Dakota investors were persuaded and on August 10, 1965, in Mountainburg, Arkansas, they met with Gatlin, Markham and Willis and formed Investors Thrift Corporation (ITC), an Arkansas corporation. The South Dakota investors put up $150,000.00 at that time for which they were to be issued non-voting shares, with all of the voting stock to be held by Markham Homes.[3]

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[3] H. T. Ringling and Robert Carter each subscribed for 60,000 shares, Andy DeHaan for 150,000 shares and Ilo Vanderboom for 40,000 shares.

Thinking that it would be easier to purchase a financial institution than to start one, Gatlin presented a letter on August 10th from Sam Sexton, Jr., one of the owners of American Home Builders, Inc. (AHB), offering to sell AHB for $500,000.00. AHB owned all of the stock of three construction companies and held voting control (68%) of Peoples Loan and Investment (PL&I), ostensibly the type of financial institution Markham Homes and ITC were looking for. Gatlin was quite familiar with PL&I as he had sold a majority of its voting stock to AHB, owned by Sexton, James Hall and Huey Smith, on July 1, 1964 for $500,000.00. To enable it to purchase the PL&I stock, AHB borrowed $700,000.00 from Texas Capital Corporation, with Sexton and Smith executing personal guarantees for the entire amount and Hall giving a personal guarantee for either $150,000.00 or $200,000.00.

An agreement for the sale of AHB dated September 2, 1965 was drawn up by Sexton with the sale price set at $200,000.00 plus assumption of the $700,000.00 loan from Texas Capital. ITC was unable to raise the funds in time to close on September 2, 1965 but after Markham made a trip to South Dakota where he successfully solicited funds from the ITC stockholders there, an option to buy contract was signed on September 9, 1965.

The option provided for payment of $150,000.00 to Sexton, Hall and Smith as a consideration for the option, which amount would also be applied on the purchase price if the option was exercised, and for forfeiture of that amount if the option was not exercised on or before January 10, 1966. Contingent upon the success of AHB, $100,000.00 of this payment was to be paid to Markham in the form of ITC stock as a commission for setting up the deal and was to be shared with Gatlin. The option contract also provided that Markham would take over immediately as general manager of AHB and that Gatlin would begin

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work on September 15th as a consultant to PL&I. If the investors chose to exercise the option, the contract required another payment of $157,500.00 to Sexton, Hall and Smith, payment of $300,000.00 to Texas Capital on or before January 10, 1966 and an additional payment of $400,000.00 to Texas Capital on or before June 30, 1966.

Investor Vanderboom traveled to Arkansas to visit and to examine the books of AHB and PL&I, but it appears that the South Dakota investors primarily relied on their agent Markham for an evaluation of AHB. Markham did check with officials of three Arkansas regulatory agencies (the State Bank Commissioner, the Securities Commissioner and the Insurance Commissioner), who informed him that PL&I was certified to operate and was conforming to all rules and regulations. Markham had CPA Jim Tuttle make a survey of AHB and PL&I and Tuttle advised him an audit of PL&I would take six months with available personnel and a minimum of three months no matter how many were employed.

After examining the financial statements of the South Dakota investors, Hall, who also was the vice-president of the City National Bank of Fort Smith, Arkansas, assured them that the bank would lend them some of the funds needed to carry out the purchase. So, on October 29, 1965, the South Dakota investors traveled to Fort Smith to obtain their loans from City National.

It is alleged that Hall had earlier represented to Markham that PL&I was worth at least a million dollars and that he made similar representations as to the financial soundness and profitability of both AHB and PL&I on October 29 to the South Dakota investors, in the presence of the president of City National, Ed Smoot. The affidavit of investor Andy DeHaan asserts that in answer to his question as to whether this was a good investment, Smoot

advised him that it was. Smoot, however, denies the entire conversation and states that he knew only that the funds loaned would be invested in ITC, that he was totally unaware that the ultimate investment of the loan proceeds would be applied on the purchase of AHB. However, inasmuch as Hall's affidavit states that the bank officers did know of his interest in AHB and of his personal guarantee of the Texas Capital loan and Smoot himself acknowledged that Hall disqualified himself on the loan transaction because of his personal interest, it is fair to infer that Smoot was aware that ITC would use the funds to apply on the purchase of AHB.

On October 29, 1965, after approval by the bank's discount committee, Smoot represented the bank in making the following loans, secured by non-voting ITC stock and Markham's guarantee: (1) $15,000.00 to Vanderboom; (2) $90,000.00 to DeHaan Livestock; (3) $10,000.00 to Ringling; (4) $25,000.00 to Carter. Hall and Smoot were both on the 9-member discount committee which reviews all sizeable loans, as was Les Greathouse who along with Smoot handled the AHB and PL&I accounts. PL&I was the bank's largest depositor as it was obligated under Arkansas law to maintain a statutory cash reserve. Since PL&I occasionally would have to borrow from the bank to maintain the required cash reserve, it routinely filed monthly financial statements with the bank and furnished the bank the Arthur Andersen audit report of PL&I completed in October of 1965.

On November 5, 1965, ITC exercised the purchase option and $157,500.00 was paid Sexton, Hall and Smith and $400,000.00 was paid Texas Capital.

On December 31, 1965, the South Dakota investors increased their loans with the bank as follows: (1) Vanderboom, from $15,000.00 to $25,000.00; (2) Ringling, from

$10,000.00 to $40,000.00; (3) DeHaan Livestock, from $90,000.00 to $105,000.00; (4) Carter, from $25,000.00 to $40,000.00. On January 10, 1966, ITC paid the final $300,000.00 owed Texas Capital.

In early 1966 a depositors' run on PL&I occurred when it was discovered that Sexton had been jailed in Brazil. He was later released without any apparent consequences.

On February 25, 1966, James Nachtigal, another South Dakotan, borrowed $50,000.00 from the City National Bank and invested it in ITC.

On July 1, 1966, AHB hired Ronald Butler, a CPA, to determine the financial condition of AHB. Although Butler apparently worked full-time into 1967, it was not until October of 1967 and the completion of the Fred Landau & Company audit that the investors learned the true financial condition of AHB. The audit allegedly revealed that AHB had a consolidated net deficit of $537,253.18 on September 30, 1965 (i. e. during the time ITC was deciding whether to exercise the option or not) and that PL&I had an adjusted net worth of $31,152.41 on June 30, 1965.

Each of the South Dakota investors made payments of principal to the bank on June 5, 1967, and all but DeHaan Livestock executed agreements extending the maturity of the notes to September 5, 1967, purportedly pending the outcome of the Landau audit.

In early November of 1967 Ilo Vanderboom, DeHaan Livestock & Grain Farms, Inc., H. T. Ringling, James Nachtigal, Robert Carter, R. S. Miskimins, Richard Adamson, Wendell Foxley, William Nash, Ervin Ortman, Herbert Ortman, Stanley Weiland, Donald Nachtigal, James Klaudt and Markham Homes, Inc., brought suit in the state court of South Dakota "for rescission and/or dam-

ages" in connection with ITC's purchase of AHB against Sexton, Hall and Smith as the sellers, and against Gatlin and the City National Bank of Fort Smith, Arkansas, for aiding, abetting and conspiring with the sellers to defraud the investors and ITC (ITC, however, was not a party to this action).

On November 11, 1967 the bank filed complaints in the United States District Court for the Western District of Arkansas seeking judgments on various notes, naming Vanderboom, DeHaan Livestock, Ringling, James Nachtigal and Carter (all of whom were plaintiffs in the South Dakota suit) and Andy DeHaan, Kenneth DeHaan and Lyle DeHaan as parties defendant in the five separate civil suits.[4]

On December 5, 1967 the District Court granted a preliminary injunction enjoining the defendants from proceeding further against the bank in the suit pending in the South Dakota court and ordered the five cases filed by the bank consolidated.

On March 13, 1968 the defendants in the five consolidated cases admitted the bank's claim, but counterclaimed on the theory that the bank was a participant in the fraudulent misrepresentation allegedly made in connection with the sale of the AHB stock, and asked that the notes sued on by the bank be cancelled and that the defendants

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[4] The defendants in the five suits broke down as follows:

(1) Case No. 19550, Ilo Vanderboom;

(2) Case No. 19551, DeHaan Livestock & Grain Farm, Inc., Andy DeHaan, Kenneth DeHaan and Lyle DeHaan;

(3) Case No. 19552, H. T. Ringling;

(4) Case No. 19553, James Nachtigal;

(5) Case No. 19554, Robert Carter.

The numbers assigned to these cases are their docket numbers on appeal to this court.

be awarded additional damages totaling $415,750.00 plus costs and attorney's fees.[5]

The preliminary injunction was made permanent on March 22, 1968, so on May 7, 1968 the defendants filed a third-party complaint seeking to join the following as parties defendant: Sexton, Hall, Smith, Gatlin, Gatlin's wife, Diamond G Ranch, Inc. (a Gatlin corporation) and Texas Capital Corporation (now TeleCom Corporation). When this third-party motion was overruled on July 10, 1968, the eight defendants, ITC, and all the other plaintiffs in the South Dakota suit except Markham Homes proceeded to file a separate civil action in the federal court on July 18th (hereinafter referred to as the companion case) against the bank, Sexton, Hall, Smith, Gatlin, Gatlin's wife, Diamond G Ranch, Inc. and Texas Capital Corporation.

On August 6, 1968 the defendant investors' motion to consolidate the instant case with the companion case was overruled.[6] The court on October 2, 1968 granted the bank's motion for summary judgment, held the defendants liable on their promissory notes to the bank and dismissed the defendants' counterclaim against the bank. *City National Bank v. Vanderboom, et al.*, 290 F. Supp. 592 (W. D. Ark. 1968).

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[5] The $415,750.00 represents the amount of additional money advanced by the various defendants and breaks down as follows:

(1) Vanderboom, $56,250.00;
(2) DeHaan Livestock & Grain Farms, Inc., $103,000.00;
(3) Ringling, $103,[redacted];
(4) Nachtigal, $5[redacted].00;
(5) Carter, $103,000.00.

[6] In the companion case on August 8, the court dismissed ITC's complaint for failure to state a claim against the bank and also granted the bank's motion for summary judgment against all the plaintiffs in the companion case, except R. S. Miskimins, whose complaint was abated until the disposition of a similar suit pending in the South Dakota courts.

The District Court found that the evidence did not establish that the bank had knowledge of the alleged fraud perpetrated by one of its officers Hall and others upon the makers of these notes and any knowledge which Hall had concerning the alleged fraud cannot be imputed to the bank since it was in Hall's interest to conceal his knowledge. The Court also ruled that the alleged fraudulent scheme was not revealed to Ed Smoot, the president of the bank and the bank's representative in the making of the loans, and that therefore the bank acted in good faith in making the loans. From its finding that the bank did not sell or offer to sell any security of any kind to the investors but merely loaned them some of the money with which to buy capital stock in ITC, the Court concluded that the bank's behavior in making these loans did not fall within the statutory coverage of the "in connection with the purchase or sale of any security" clause of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5.

In addition, the Court held that knowledge obtained or which would have been obtained in exercise of reasonable diligence by the investors' agent Markham was imputable to the investors, and thus their giving of renewal notes and making partial payments over a year and a half after the loan transactions waived any fraud in the transactions and they as makers were estopped from pleading such defense in actions on renewal notes. The final ground for the District Court's holding was that the bank was a holder in due course, so even if Hall had made false statements or concealed facts relative to the sale of AHB to the investors, such fraud was not a defense to this action on the notes brought by the bank since only fraud as to the nature of the instrument itself is a defense to an action by a holder in due course.

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I. *STANDING TO SUE UNDER RULE 10b-5*

Although Rule 10b-5 itself does not provide for a private cause of action, civil liability has been generally implied by the federal circuits.[7] However, there appears to be a serious question as to the availability of this 10b-5 counterclaim to the investors individually due to the "purchaser-seller" standing requirement imposed by the "in connection with the purchase or sale of any security" clause of both the statute and the rule. Although a private shareholder plaintiff seeking injunctive relief under Rule 10b-5 has been held to have standing even though he was not a purchaser or seller, *Mutual Shares Corp. v. Genesco, Inc.*, 384 F. 2d 540, 546-47 (2d Cir. 1967), we note that that same court dismissed an action for damages filed by a plaintiff who had not sold any of his shares but was holding them at a loss. In *Greenstein v. Paul*, 400 F. 2d 580 (2d Cir. 1968), the Second Circuit held:

> "It has long been the rule in this circuit that to maintain an action under § 10(b) of the Act and Rule 10b-5 of the Securities and Exchange Commission the plaintiff must have been a seller of the stock involved. *Birnbaum v. Newport Steel Corp.*, 193 F. 2d 461 (C. A. 2, 1952), cert. denied 343 U. S. 956, 72 S. Ct. 1051, 96 L. Ed. 1356 (1952). Although criticized, *Entel v. Allen*, 270 F. Supp. 60, 70 (S. D. N. Y., 1967), it is still the rule at least insofar as actions for damages are concerned. *Mutual Shares Corp. v. Genesco, Inc.*" *Id.* at 581.

We are aware that strict application of this standing rule has worked hardships and that courts have fashioned

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[7] Without enumerating the cases here, an analysis so concluding is noted in 6 L. Loss, *Securities Regulation* 3871 (1969). The cases cited by Loss merit the conclusion that "[t]he existence of a private cause of action [under Rule 10b-5] has now been recognized—whether by way of direct holding or *obiter* or *sub silentio*—by ten of the eleven Courts of Appeals." Cases are cited on pp. 3871-73.

mitigating doctrines granting standing to plaintiffs who are not technically purchasers or sellers of securities. *E. g. Mader v. Armel*, 402 F. 2d 158, 160-61 (6th Cir. 1968), *cert. denied*, 394 U. S. 930 (1969) (merger deemed a "sale"); *Vine v. Beneficial Finance Co.*, 374 F. 2d 627, 632-36 (2d Cir.), *cert. denied*, 389 U. S. 970 (1967) (forced or constructive sale due to merger); *Commerce Reporting Co. v. Puretec, Inc.*, 290 F. Supp. 715, 718-19 (S. D. N. Y. 1968) (person prevented from selling because of alleged fraud has standing to sue); *see generally* Comment, *SEC. Rule 10b-5—"In Connection With the Purchase or Sale of Any Security" Restriction: Need for Analytical Precision*, 5 Colum. J. L. & Soc. Prob. 28, 42-45 (1969).

The investors argue that they should be deemed defrauded purchasers of AHB for the purposes of this counterclaim because ITC, the actual purchaser, was never an operating company and its corporate structure was a mere conduit which was convenient for the investors to use in making this purchase, and because the bank knew that the funds loaned to the investors were for the purpose of buying AHB.

The only authorities cited by the investors for their theory that for the purpose of determining standing to sue under Rule 10b-5 they should be deemed the purchasers of AHB are cases dealing with "piercing the corporate veil." Under this theory courts have disregarded the corporate entity when it was being used to defeat public convenience, justify wrong, protect fraud, or defend crime. *Majestic Co. v. Orpheum Circuit, Inc.*, 21 F. 2d 720 (8th Cir. 1927). Thus, in order to reach an equitable result courts have pierced the corporate veil and held stockholders personally liable for corporate obligations. This doctrine has no application in the instant case since ITC committed no fraud, rather ITC was the allegedly defrauded party. Also persuasive is the fact that the defendant investors do not comprise all of the shareholders

of ITC. Furthermore, ITC was not a mere conduit formed by these investors to purchase AHB. ITC had its own separate corporate structure and only subsequent to its incorporation did Gatlin propose that ITC purchase another financial institution rather than starting one of its own. Under these circumstances we feel the corporate integrity of ITC must be respected and not glibly and casually disregarded.

Therefore, we conclude that the defendant investors do not satisfy the "purchaser-seller" standing requirement of Section 10(b) and Rule 10b-5. The proper course of action for these investors was for them to raise their 10b-5 claim by bringing a derivative suit on behalf of ITC. *E. g., Schoenbaum v. Firstbrook*, 405 F. 2d 215, 219 (2d Cir. 1968) (en banc), *cert. denied*, 395 U. S. 906 (1969). Had the investors brought a derivative suit on behalf of ITC, the "purchaser-seller" standing requirement would have been satisfied by ITC. The stockholder who brings a derivative suit need not personally be a purchaser or seller, it is sufficient that he allege the corporation purchased or sold shares in connection with some fraudulent activity. *Surowitz v. Hilton Hotels Corp.*, 342 F. 2d 596, 604 (7th Cir. 1965), *rev'd on other grounds*, 383 U. S. 363 (1966); *Greater Iowa Corp. v. McLendon*, 378 F. 2d 783, 791 (8th Cir. 1967).

II. *STATUTORY COVERAGE OF SECTION 10(b)*[8]

In addition to the investors' lack of standing to raise their 10b-5 counterclaim, we find that the alleged misrepresentations and nondisclosures on the part of the bank do not fall within the statutory coverage of the "in con-

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[8] As defined by one commentator, statutory coverage means "the type of wrongdoing actionable under rule 10b-5." Comment, *SEC. Rule 10b-5—"In Connection With the Purchase or Sale of Any Security" Restriction: Need for Analytical Precision*, 5 Colum. J. L. & Soc. Prob. 28, 28 n. 4 (1969).

nection with the purchase or sale of any security" clause. The defendant investors allege that Smoot misrepresented the financial condition of AHB on October 29, 1965, and that he silently acquiesced to misrepresentations made by Hall on that date when he knew or had reason to know that such representations were untrue, because the bank had in its possession monthly financial reports from PL&I and an Arthur Andersen audit of PL&I completed sometime in October of 1965 and because Smoot was the bank official who overlooked the PL&I account.

It is apparent that the extent of the coverage and liability imposed under Section 10(b) of the Securities Exchange Act and Rule 10b-5 has not as yet been precisely defined. As noted by the Supreme Court in *SEC v. National Securities, Inc.*, 393 U. S. 453 (1969), the statutory section and the rule constitute one of several broad antifraud provisions set forth in the securities law in which application of the "allegedly proscribed conduct must have been 'in connection with the purchase or sale of any security.' The relevant definitional sections of the 1934 Act are for the most part unhelpful * * *. Consequently, we must ask whether respondents' alleged conduct is the type of fraudulent behavior which was meant to be forbidden by the statute and the rule." *Id.* at 466-67.

The Second Circuit recently considered the question of statutory coverage under Rule 10b-5 and fashioned a two-step test applicable to both private damage actions and suits for injunctive relief. In *Heit v. Weitzen*, 402 F. 2d 909 (2d Cir. 1968), *cert. denied*, 395 U. S. 903 (1969), a private damage action under 10b-5, the Court made clear that the first step of this statutory coverage test is governed by principles enunciated in *SEC v. Texas Gulf Sulphur Co.*, 401 F. 2d 833 (2d Cir. 1968) (en banc), *cert. denied*, 394 U. S. 976 (1969), which "construed the 'in connection with' requirement broadly and held that the clause was satisfied whenever a device was employed 'of a sort

that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities,' *SEC v. Texas Gulf Sulphur Co.*, at 860." *Id.* at 913. If the plaintiff has met the requirements of this "in connection with" test, *Heit* states that the second step of the statutory coverage test is "the question of the standard by which the conduct of the defendants is to be judged." *Id.* Although the Second Circuit held that proof of negligence was sufficient to sustain an action for injunctive relief under Rule 10b-5(2) in *Texas Gulf Sulphur*, *Heit* did not reach the question of whether negligence would likewise suffice in a private suit for damages.

Since we held in *Myzel v. Fields*, 386 F. 2d 718, 734-35 (8th Cir. 1967), *cert. denied*, 390 U. S. 951 (1968) that "[p]roof of 'scienter,' i. e., knowledge of the falseness of the impression produced by the statements or omissions made, is not required under Section 10(b)," we disagree with the second step of the Second Circuit's test to the extent that it does not reflect recognition of a negligence standard but otherwise is in accord with the standard formulated.[9]

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[9] We note that the 9th Circuit is the only other Court of Appeals which has squarely recognized a private cause of action under Rule 10b-5 for negligent misrepresentations. *Ellis v. Carter*, 291 F. 2d 270 (9th Cir. 1961). Notwithstanding Judge Friendly's statements in his concurring opinion in *Texas Gulf Sulphur* that the standard by which the conduct of the defendants is to be judged should embody a scienter requirement in private damage suits, the following language from the majority opinion permits the inference that the Second Circuit may be on the verge of dropping the scienter requirement in private actions, too:

"[A] review of other sections of the Act from which Rule 10b-5 seems to have been drawn suggests that the implementation of a standard of conduct that encompasses negligence as well as active fraud comports with the administrative and the legislative purposes underlying the Rule. . . . [T]his position is not . . . irreconcilable with previous language in this circuit, because *'some form* of the traditional scienter requirement,' . . . sometimes defined as 'fraud', . . . is preserved. This requirement, whether it be termed lack of

We think this two-step test breaks down as follows: (1) With regard to misrepresentations, the question is whether a reasonable investor, in light of the facts existing at the time of the misrepresentation and in the exercise of due care, would have been entitled to rely upon the misrepresentation. With regard to nondisclosures, the issue becomes whether a reasonable investor, in light of the facts existing at the time of the nondisclosure and in the exercise of due care, would have been entitled to receive full disclosure from the party charged and would have acted differently had the alleged nondisclosure not occurred. (2) If the plaintiff satisfies this "in connection with" step, it then becomes necessary to determine whether the defendant's misrepresentation or nondisclosure was made with scienter or from a lack of due diligence.[10] *See Texas Gulf Sulphur Co., supra* at 863.

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diligence, constructive fraud, or unreasonable or negligent conduct, remains implicit in this standard, a standard that promotes the deterrence objective of the Rule." *Texas Gulf Sulphur Co., supra* at 855.

Although Professor Loss indicates concern that "Clause (2) of the rule, which refers merely to material misstatements and half-truths without using fraud or *scienter* language of any kind," may be an impermissible implementation of a statutory provision that speaks in terms of "any manipulative or deceptive device or contrivance", he concludes that "[t]he common law development, reinforced by the general statutory purpose, might well justify extension of Clause (2) to something at least approaching simple negligence." 6 L. Loss, *Securities Regulation* 3885 (1969). *See generally* Comment, *Negligent Misrepresentations Under Rule 10b-5*, 32 U. Chi. L. Rev. 824 (1965).

[10] One commentator who argues that a negligence standard based on the concept of access to information should obtain in 10b-5(2) private actions has suggested that reasonable reliance should be a condition to all private actions based on negligent misrepresentations under 10b-5.

> "It is not the defendant's position as insider per se which imposes the duty on him, but rather the possession of material facts to which the other party has no access.
>
> * * * * * * * *
>
> "Not only should the plaintiff have to prove that he relied on the defendant's statements, but he must convince the trier of

It should be noted from the outset that this "reasonable investor" test is an objective standard. Whether an investor did in fact rely upon a misrepresentation is immaterial for the purpose of determining statutory coverage, though reliance is a predicate for recovery once coverage is established. In applying this test to the instant case, we find a reasonable investor would not have relied upon any representations made by Smoot and that the bank did not owe a duty of full disclosure to the investors.

The investors had access to all the books and records of AHB and PL&I during the four-month option period. The investors allege they have never seen the Arthur Andersen audit of PL&I, that it is as yet still undiscovered by them. Regardless of what this audit might show, the fact remains that the audit was made for PL&I—not the bank. The investors either had access to this audit report, which was ostensibly in AHB files, or they had the right to secure it from the auditors. Markham, the investors' agent, knew of the report, had access to it and could have produced it if desired. As this court stated in *Myzel v. Fields*, 386 F. 2d at 736:

> "[T]here is no duty to disclose information to one who reasonably should already be aware of it. Nor

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fact that his reliance was reasonable under all the circumstances at the time. In this way recovery would be denied to those who, because of their 'business sophistication,' acumen, or ready access to the information involved, could reasonably be expected to exercise a higher degree of care and investigation in their dealings."

Comment, *Negligent Misrepresentations Under Rule 10b-5*, 32 U. Chi. L. Rev. 824, 841-42 (1965) (footnotes omitted).

We feel that step one of our test properly reflects these considerations as the objective standard of a reasonable investor exercising due care in light of all facts effectively imposes a duty of reasonable investigation, thereby limiting the class of investors who will be protected under 10b-5(2) to conscientious buyers and sellers in good faith.

> is there the necessity for one insider to 'search out details' for another insider, in the same sense that such a duty might exist towards others less informed."

Further support for our conclusion is found in *Kohler v. Kohler Co.*, 319 F. 2d 634 (7th Cir. 1963), where the Seventh Circuit held that the failure of a director of the corporation to disclose material facts to the plaintiff will not lead to liability under 10b-5 where the plaintiff himself has the ability and opportunity to discover those facts easily. The Supreme Court has also had occasion to state this general principle:

> "When the means of knowledge are open and at hand or furnished to the purchaser or his agent and no effort is made to prevent the party from using them, . . . he will not be heard to say that he has been deceived to his injury by the misrepresentations of the vendor." *Shappirio v. Goldberg*, 192 U. S. 232, 241-42 (1904).

Since the investors in the case at bar had ready access to the information involved, it is reasonable to expect them to exercise a higher degree of care than third parties who were not sellers and did not profit from the sale but who might have had some peripheral or general knowledge about the financial condition of AHB.

Finally, we think the trial court was correct in its conclusion that even if Hall, the bank's vice-president, did conceal material facts from the investors, neither his action nor any knowledge he possessed of the alleged fraudulent scheme can be imputed to the bank under Arkansas law. The general agency rule that knowledge acquired by an officer or agent of a corporation while acting in his official capacity or within the scope of his duties will be imputed to the corporation is applicable to banks. *Hooten v. State*, 119 Ark. 334, 178 S. W. 310, 312-13 (1915). How-

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ever, where it is in the officer's interest to conceal his knowledge, his knowledge will not be imputed to the bank unless he is the sole representative of the bank in the transaction. *Little Red River Levee Dist. No. 2 v. Garrett*, 154 Ark. 76, 242 S. W. 555, 557-58 (1922).

Hall's personal interest in AHB was disclosed both to the investors and the bank and he disqualified himself from the loan transaction. Nondisclosure or misrepresentation of the real financial condition of the two corporations by Hall cannot be imputed to the bank under the doctrine of respondeat superior since it was manifest to all that Hall, as seller, was not acting in an agency capacity for the bank. Furthermore, any knowledge of a fraudulent scheme which Hall may have had cannot be imputed to the bank because Hall's noninvolvement in the loan transaction precludes the possibility that his knowledge could be imputed to the bank under the sole actor doctrine.

No reported case has extended Rule 10b-5's umbrella of protection over such a wide area as is attempted by the investors in this case, nor has a basis been demonstrated for disregarding the corporate integrity of ITC, which was organized by the investors and their agent Markham for the purpose of setting up a public financial institution to secure funds for Markham's enterprises and then later utilized as a corporate entity to purchase control of AHB and its related companies.

Since the defendant investors are not entitled to recoup against the bank for their unfortunate investments with Markham and ITC under the more liberal and broader coverage of Rule 10b-5, it is clear that they have not shown any basis for a common law fraud action under Arkansas law against the plaintiff bank.

Judgment affirmed.

APPENDIX "B"

Judgment

United States Court of Appeals
For the Eighth Circuit

September Term, 1969

Nos. 19,550, 19,551, 19,552, 19,553, and 19,554

The City National Bank of Fort Smith, Arkansas, a National Banking Association,

Appellee,

vs.

Ilo Vanderboom (Appellant in No. 19,550), DeHaan Livestock & Grain Farms, Inc., a South Dakota Corporation, Andy D. DeHaan, Kenneth J. DeHaan, and Lyle R. DeHaan (Appellants in No. 19,551), H. T. Ringling (Appellant in No. 19,552), James Nachtigal (Appellant in No. 19,553), and Robert Carter (Appellant in No. 19,554).

Appeals From the United States District Court for the Western District of Arkansas

These causes came on to be heard on the record from the United States District Court for the Western District of Arkansas and were argued by counsel.

On Consideration Whereof, it is now here ordered and adjudged by this Court, that the judgment of the said District Court, in these causes, be, and the same is hereby, affirmed.

February 20, 1970

APPENDIX "C"

Civil Nos. 2103, 2104, 2105, 2106, 2107

United States District Court, Western District of Arkansas, Fort Smith Division

(Caption omitted)

Decided September 27, 1968

Before: John E. Miller, United States Senior District Judge

Opinion

A motion for summary judgment was filed by the plaintiff in each of these cases on August 5, 1968. Prior to the filing of the motion, the plaintiff had filed a motion for summary judgment in each of the cases on April 8, 1968. The court considered the earlier motion, and submitted to counsel a letter opinion, and an order was entered overruling the motion on May 15, 1968. (Counsel for plaintiff have requested that the earlier motion be again considered in connection with the present motion of August 5, 1968.)

The complaint in each of the following cases was filed November 11, 1967.

In Civil Action 2103 the plaintiff is seeking judgment for $20,555.64 with interest from May 30, 1967.

In Civil Action 2104 the plaintiff is seeking judgment for $70,000 with interest from June 1, 1967.

In Civil Action 2105 the plaintiff is seeking judgment for $44,444.44 with interest from May 30, 1967.

In Civil Action 2106 the plaintiff is seeking judgment for $45,833.34 with interest from May 30, 1967.

In Civil Action 2107 the plaintiff is seeking judgment for $32,222.22 with interest from May 30, 1967.

Subsequent to the commencement of Civil Actions 2103-2107 the plaintiff on November 16, 1967, filed a complaint (Civil Action 2103) against these same defendants and others to enjoin and restrain said parties from proceeding with Case No. 67-871 filed by them in the Circuit Court, Second Judicial Circuit, County of Minnehaha, State of South Dakota, against the plaintiff. The court, after a full hearing in Civil 2108, issued a preliminary injunction enjoining the parties from prosecuting said suit in the state court of South Dakota. Later the plaintiffs in the South Dakota case dismissed their complaint, and on March 13, 1968, the defendants in the instant case filed their separate answers and counterclaims, in which they each admitted the execution of the notes, the receipt of the money from plaintiff, the payments made thereon by them, and extensions granted by plaintiff, but denied that they were liable for the reasons set forth in their counterclaims. In the counterclaim, the defendants alleged:

> "The defendant and counter-claimant states that for sometime prior to, at the time of, and subsequent to the execution of the note, one James S. Hall, was a vice president and agent of the plaintiff and that Hall, in conjunction with others, worked out a scheme or method of fraudulent misrepresentations whereby this defendant and counter-claimant and others would use personal funds and funds obtained from the plaintiff for the ultimate purchase of all of the stock in an Arkansas corporation called American Home Builders, Inc., which was represented by Hall and others to this defendant and counter-claimant and others to be a well-managed, solvent corporation, when in fact at the time of these misrepresentations and at the time of the execution of the note in question and subse-

quent thereto American Home Builders was in fact insolvent. At all times herein mentioned, Hall owned approximately one-third of the stock in American Home Builders and fraudulently induced this defendant and counter-claimant and others to obtain the loan by the execution of the note in question, all in violation of 12 U. S. C. A., Section 375 A, and 18 U. S. C. A., Section 220, and the rules and regulations thereunder pertaining to national banks, while an officer and agent of the plaintiff, and further the plaintiff at all times herein mentioned did not follow normal banking practices and knew or should have known that by advancing the money under the note in question, it was participating in the scheme whereby this defendant and others would purchase an insolvent corporation with the proceeds of the note and other personal money, all to the detriment of this defendant and counter-claimant, and to the financial benefit and gain of its officer and agent and itself, all in violation of the U. S. Code sections hereinabove referred to and further in violation of the common law."

On April 5, 1968, the plaintiff filed its reply to the counterclaims, in which it alleged:

"1. The defendant's purported counterclaim appears to be set out in Paragraph 7 thereof, and the plaintiff denies each and every allegation made and attempted to be made in said paragraph, and denies that defendant is entitled to the relief prayed against plaintiff therein.

"2. Further answering, plaintiff alleges that by defendant's admission of making payments on the note described in the complaint, defendant waived his right to assert his alleged counterclaim, and is now estopped from doing so.

"3. Further answering, plaintiff alleges it is a holder in due course of the note described in the complaint, and as such holds same free from the claim sought to be asserted by defendant in the counterclaim.

"4. Further answering, plaintiff states that said counter-claim fails to state a claim upon which relief can be granted.

"Wherefore, without waiving the foregoing motion, plaintiff prays that the counterclaim herein be dismissed and that plaintiff have the relief first prayed in its complaint against the defendant."

Following the filing of the reply to the counterclaim, the defendants decided to obtain other counsel and employed their present counsel, who filed motions for extensions of time to familiarize himself with the issues, which extensions were granted. Then began the filing of a series of interrogatories which will later be considered along with all other documents in support of the motion for summary judgment.

On August 13, 1968, the defendants, after obtaining leave of court, filed an amended counterclaim, which supplements and enlarges the allegations contained in the original counterclaim. On August 20, 1968, plaintiff filed its reply to the amended counterclaim.

In the motion for summary judgment now before the court in Civil Actions 2103-2107, the plaintiff alleged:

"I

"The complaints, answers, counterclaims and replies thereto in each of said causes of action, and the affidavits, depositions and certificates and exhibits thereto, all of which are attached hereto, show that there is no genuine issue as to any material fact,

either as to the complaints or as to the counter-claims in each of said causes, and that plaintiff, as a matter of law, is entitled to declaratory judgments as prayed in the complaints against the defendants in each of Causes Nos. 2103, 2104, 2105, 2106, 2107 and 2108, and to judgments dismissing the counterclaims in each and all of said causes.

"II

"In support of this motion, plaintiff attaches hereto the following documents as Exhibits identified as set out below, each of which is made a part hereof:

Exhibit 1—Affidavit of Austin Gatlin.

Exhibit 2—Affidavit of Sam Sexton, Jr.

Exhibit 3—Copy of discovery deposition taken by defendants of Austin Gatlin.

Exhibit 4—Copy of discovery deposition taken by defendants of Sam Sexton, Jr.

Exhibit 5—Copy of discovery deposition taken by defendants of James S. Hall.

Exhibits 6 to 12—Copies of interrogatories served upon and verified answers thereto served by each of the defendants in each of the above causes.

Exhibit 13—Copy of interrogatories served upon and verified answers thereto served by plaintiff's president, Edward H. Smoot.

Exhibit 14—Copy of verified complaint filed and served by these defendants herein as plaintiffs in Cause No. FS-68-C-27 in this court on July 19, 1968.

"III

"Incorporated herein by reference are other pleadings filed herein by defendants with motions for leave to file same:

Exhibit 15 (by reference)—Third-Party Complaint.

Exhibits 16 to 20 (by reference)—Amended Counterclaims in causes 2103, 2104, 2105, 2106, and 2107.

"Wherefore, plaintiff prays for summary judgment granting the relief above described in each of said causes, and that the court fix a time and place for hearing same, not sooner than ten days after service hereof."

In the response of defendants to the motion, each of them alleged:

"1. The plaintiff is not entitled to a declaratory judgment upon the complaint filed against each of the defendants, and the plaintiff is not entitled to a summary judgment against the defendants-counterclaimants on their respective counterclaims filed in Civil Actions Nos. 2103, 2104, 2105, 2106, and 2107.

"2. Genuine issues of material facts exist between the counterclaimants and the plaintiff and as a matter of law, the plaintiff is not entitled to a summary judgment against any one of the counterclaimants in the referenced causes.

"3. In support of each defendant and counterclaimant's opposition to the motion for summary judgment, the defendants and counterclaimants attach hereto the following documents and exhibits identified as set out below, each of which is made a part hereof:

Exhibit 1—Affidavit of Maurice W. Markham, Jr., with further exhibits attached.

Exhibit 2—Summary of deposition of Austin Gatlin.

Exhibit 3—Summary of deposition of James S. Hall.

Exhibit 4—Summary of deposition of Sam Sexton, Jr.

Exhibit 5—Affidavit of Ilo Vanderboom.

Exhibit 6—Affidavit of Andy DeHaan.

Exhibit 7—Affidavit of James Nachtigal.

Exhibit 8—Affidavit of H. T. Ringling.

Exhibit 9—Affidavit of Robert Carter.

"4. Incorporated herein by reference are the following:

Copies of interrogatories served upon and verified answers thereto served by each of the defendants and counterclaimants in each of the above causes.
Copies of interrogatories served upon and verified answers thereto served by plaintiff's president, Edward H. Smoot.
The counterclaims as amended of each of the defendants and counterclaimants in each of the above causes.

"Wherefore, defendants and counterclaimants pray that the motion for a declaratory judgment on the complaint and the motions for summary judgment against each of the defendants and counterclaimants on their counterclaims filed herein be denied and for all other proper relief."

There is complete diversity of citizenship between the plaintiff and all the defendants. The amount involved in each suit exceeds the sum of $10,000, exclusive of interest and costs, and thus the court has jurisdiction.

The court has heretofore referred to the first motion for summary judgment filed by plaintiff on April 8, 1968,

and to the incorporation by reference of that motion in the brief of plaintiff.

In the motion of April 8, 1968, the plaintiff alleged that the pleadings showed that there is no genuine issue as to any material fact, and that plaintiff is entitled to a summary judgment as prayed in cases Nos. 2103-2107.

In support of the motion plaintiff in its brief, inter alia, stated that each defendant had admitted the execution of the notes, the payments, renewals and extensions thereof, and that the balance due the plaintiff as alleged is correct; that the defendants received the proceeds of the loans; that the notes were executed for value. The plaintiff argued that it was a holder in due course of each note; that the nebulous allegations of the counterclaims do not affect the rights of plaintiff; that a principal is not charged with knowledge of an agent who may have engaged in a fraudulent enterprise and that any knowledge of Hall is not imputable to plaintiff. None of the proceeds of the notes went to the bank in any manner; that the defendants, by their conduct, have waived any claim against plaintiff; and that they are now estopped from asserting the defense as set forth in the counterclaims; that when the notes were renewed and extensions received, the defendants had knowledge of all facts relative to the loans, and notwithstanding that knowledge made partial payments and months afterwards renewed the notes and received extensions, and are therefore estopped from now contending that the bank was guilty of any fraud in making the loans.[1]

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[1] In support of the contentions thus made, the plaintiff cited Ark. Stat. Ann., §§ 85-3-302 and 85-3-305, defining a holder in due course; Poe v. Taylor (1932), 186 Ark. 700, 55 S. W. 2d 74; Great American Indemnity Co. v. First National Bank (10 Cir. 1938), 100 F. 2d 763; Anderson v. General American Life Ins. Co. (6 Cir. 1944), 141 F. 2d 898; Schram v. Burt (6 Cir. 1940), 111 F. 2d 557, in which the court at page 564 quoted from Farm-

At that time the defendants were represented by counsel other than their present counsel, and in the brief in opposition to the motion, counsel stated:

> "It is defendant's position that the plaintiff is not a 'holder in due course' with respect to the notes in question due to the fact that it did not take the notes 'in good faith * * * without notice of any defense.' "

In discussing the knowledge of the bank which defendants contend was imputed because of the interest of one of its officers in the corporations which defendants bought, counsel stated:

> "Assuming that the knowledge is imputed, and in view of the benefit to the bank through the perpetuation of a good customer, and the benefit to the bank officer through the relief from the guarantee of the Texas Capital note, all of which are alleged in the counterclaim in the third party complaint, the bank becomes a party to the fraud alleged in the pleadings. The bank could not then be a holder in due course with respect to the notes which it received in this tainted transaction."

The court denied the first motion of defendants, and in the letter opinion of May 15, 1968, addressed to the attorneys and filed in the Clerk's office, the court, inter alia, stated:

> "Each defendant has admitted the execution of the note or notes sued upon and that he has received the proceeds derived from the loan made to him. Each defendant has made payments, and there is no dispute about the correctness of the amount remaining due on

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ers' & Merchants' National Bank v. Smith, 8 Cir., 77 F. 129; Sebastian County Bank v. Gann (1915), 121 Ark. 115, 180 S. W. 754, on waiver of defense of fraud; and Harrington v. Citizens' Investment & Security Co. (1923), 160 Ark. 320, 245 S. W. 831.

each note. Neither is there any dispute about each defendant being in default.

"The sum and substance of the claim of each defendant is that an official of the bank, the then Vice President, together with certain unidentified associates, falsely represented to the defendants the financial condition of the various corporations, the capital stock of which the defendants purchased with the proceeds of the loans.

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"None of the pleadings sets forth any dates except the dates of the notes and the payments and extensions received by each defendant. The date of the purchase of the alleged insolvent corporations is not stated, and there is nothing to guide the court, in the pleadings, as to what the status of the entire transaction was when the payments were made and the extensions granted.

"In my opinion, the burden is upon the defendants to show notice to the bank of the alleged fraudulent scheme at the time the notes were executed. The mere fact that Hall was a Vice President of the bank is not sufficient unless the proof goes further to meet the requirements of the law and to give notice to the official of the bank who made the loans. If defendants meet that, then in all probability the burden of proof would shift to the plaintiff to show that when the payments were made and extensions obtained, the defendants at that time knew or should have known of the defenses that are now alleged against the notes."

The plaintiff now contends that the present motion is supported by affidavits, depositions, pleadings, interrogatories and answers thereto, and that these documents conclusively establish the defense of waiver and estoppel pleaded by plaintiff as a complete defense to each counterclaim.

The defendants contend that they were defrauded by the individuals with whom they dealt in buying the capital stock in various corporations; that the plaintiff aided said individuals in the perpetuation of the alleged fraud and that the plaintiff is liable to them, and that "an issue of fact is clearly presented as to whether or not Mr. Smoot or other officers of the City National Bank made overt misrepresentations of the soundness of American Home Builders, Inc., and Peoples Loan & Investment Company to each of the defendants and counterclaimants. While the defendants and counterclaimants did not purchase the stock in issue from the City National Bank, this is no requirement for their recovery under Rule 10b-5 of the Securities and Exchange Commission and the decisions of the courts thereunder."

Rule 56(c), Fed. R. Civ. P., provides:

> "The judgment sought shall be rendered forthwith if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law."

Subsection (e) of the rule provides:

> "Supporting and opposing affidavits shall be made on personal knowledge, shall set forth such facts as would be admissible in evidence, and shall show affirmatively that the affiant is competent to testify to the matters stated therein. Sworn or certified copies of all papers or parts thereof referred to in an affidavit shall be attached thereto or served therewith. The court may permit affidavits to be supplemented or opposed by depositions, answers to interrogatories, or further affidavits. When a motion for summary judgment is made and supported as provided in this

rule, an adverse party may not rest upon the mere allegations or denials of his pleading, but his response, by affidavits or as otherwise provided in this rule, must set forth specific facts showing that there is a genuine issue for trial. If he does not so respond, summary judgment, if appropriate, shall be entered against him."

In Poller v. Columbia Broadcasting System (1962), 368 U. S. 464, 82 S. Ct. 486, 7 L. Ed. 2d 458, the court at page 488 of 82 S. Ct. said:

"Summary judgment should be entered only when the pleadings, depositions, affidavits, and admissions filed in the case 'show that [except as to the amount of damages] there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law.' Rule 56(c), Fed. Rules Civ. Proc., 28 U. S. C. A. This rule authorizes summary judgment 'only where the moving party is entitled to judgment as a matter of law, where it is quite clear what the truth is, * * * [and where] no genuine issue remains for trial * * * [for] the purpose of the rule is not to cut litigants off from their right of trial by jury if they really have issues to try.' Sartor v. Arkansas Natural Gas Corp., 321 U. S. 620, 627, 64 S. Ct. 724, 728, 88 L. Ed. 967 (1944)."

In Chicago Great Western Ry. Co. v. Casura (8 Cir. 1956), 234 F. 2d 441, the court at page 447 said:

"If * * * reasonable minds might reach different conclusions, then the case presented fact issues to be submitted to the jury and not questions of law to be determined by the court. Gunning v. Cooley, 281 U. S. 90, 50 S. Ct. 231, 74 L. Ed. 720; Wellshear v. Brown, 8 Cir., 231 F. 2d 612; Chicago Great Western Ry. Co. v. Scovel, 8 Cir., 232 F. 2d 952."

In Chambers v. United States (8 Cir. 1966), 357 F. 2d 224, the court at page 227 said:

> "We have consistently held that summary judgment is appropriate where, had the case gone to trial, a directed verdict would have been required. Wolf v. Schaben, 272 F. 2d 737 (8th Cir. 1959); Rubenstein v. Dr. Pepper Co., 228 F. 2d 528, 532-533 (8th Cir. 1955); Durasteel v. Great Lakes Steel Corp., 205 F. 2d 438, 441 (8th Cir. 1953).
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> "The purpose of our summary judgment rule is to expeditiously determine cases without necessity for formal trial where there is no substantial issue of fact and is in the nature of an inquiry to determine whether genuine issues of fact exist. If no factual dispute exists and the complaint does not state a cause of action, it should be disposed of by summary judgment rather than exposing the litigants to unnecessary delay, work and expense in going to trial when the trial judge would be bound to direct a verdict in movant's favor after all evidence is adduced."

In 6 Moore's Federal Practice, 2d Ed., ¶ 56.04[2], at page 2066, the learned author said:

> "In accordance with the theory of a directed verdict, all inferences of fact from the proffered proofs must be drawn against the movant and in favor of the party opposing the motion. And, also in accord with the theory of a directed verdict, a court should not grant summary judgment, where it could not properly direct a verdict, although it might properly set a verdict aside as against the weight of the evidence."

In the consideration of the record and in determining whether there exists any genuine issue as to material fact,

the court is of the opinion that the status of the chief witness of the defendants, M. W. Markham, should be determined.

In the suit that was filed by the present defendants and others in the state court in South Dakota, notice of which was given November 6, 1967, against the plaintiff bank, Austin Gatlin, James S. Hall, Sam Sexton, Jr., and Charles H. Smith, it was alleged in paragraph 3.3 of the complaint that Markham, "acting at the instance of said defendants, * * * made frequent trips from Arkansas to South Dakota by airplane where he was instrumental in causing the plaintiffs and others to subscribe money for loans and for the purchase of stock in Investors Thrift Corporation, so that by September 9, 1965, he was enabled on behalf of Investors Thrift Corporation to make the down payment on a Purchase Agreement for the purchase of 100 percent of the issued and outstanding stock of said American Home Builders, Inc."

In paragraph 9, page 3, of the amended counterclaim filed in Civil 2103, it is alleged that the defendant-counterclaimant Ilo Vanderboom authorized Markham to enter into a contract to purchase the stock of American Home Builders, Inc. (The counterclaim in each case is substantially similar to all the others.)

Other allegations are reflected in the complaint which establish without doubt that the present defendants at the time they filed the suit in the state court in South Dakota were claiming that Markham was the agent of the plaintiff bank and that it was he who represented the bank in the entire transaction. For instance, in paragraph 4.3, page 10, of that complaint, it is alleged that Markham was the emissary and agent of the bank and other individuals, and that "Markham personally conducted a large and substantial part of the negotiations for the sale of said

securities for the defendants within the State of South Dakota."

In the affidavit of Markham, page 6, he stated:

> "In the September 9th contract, Austin Gatlin had provided himself a salary from Peoples Loan for management services commencing September 19, 1965. After the September contract, I was busy raising additional money necessary to complete the pay off to Texas Capital Corporation. Huey Smith continued as President of American Home Builders, Inc., until about the first of December 1965. Austin Gatlin and Sam Sexton controlled Peoples Loan and Investment Company until November 5, 1965 [Nov. 2, 1965] and after Mr. Sexton left, Mr. Gatlin ran the Peoples Loan and Investment Company, while I continued to raise the additional funds required to complete the pay off to Texas Capital Corporation."

Beginning on page 12 of his affidavit, Markham stated that after the exercise of the option, Gatlin began to complain about not receiving 50,000 shares of stock in Investors Thrift Corporation.

> "He threatened to quit and sue Peoples Loan and Investment Company, Investors Thrift Corporation and me to get the 50,000 shares of stock. Jimmy Willis and I bought his right to the 50,000 shares of Investors Thrift Corporation stock for $50,000. Markham Homes, Inc., Willis and I individually executed a $50,000 note to Gatlin on November 17, 1965, which has been paid."

Markham further stated:

> "After the execution of the note, Mr. Gatlin promised to remain and work for Peoples Loan and Investment Company as originally agreed. Instead of

doing this, he commenced to undermine me with the South Dakota investors, which failed. He then attempted to get a management contract from the directors of Peoples Loan and Investment Company, but was unsuccessful. Because of these maneuvers, I had to ask Mr. Gatlin to leave and began to manage Peoples Loan and Investment Company myself, which I never had any intention of doing prior to this time."

The indisputable fact is that Markham was the agent and representative of the defendants in all negotiations between defendants and Hall, Sexton and Smith.

The witness, M. W. Markham, graduated in 1954 from Oklahoma State University with a degree of Veterinary Medicine. He immediately moved to Platte, S. D., and established a veterinary practice there. In 1960 he and his brother-in-law, Jimmy Willis, established Markham Homes, Inc., and engaged in building shell homes in the northeast Oklahoma area using their own capital. By 1962 most of the capital was obligated in the shell home financing. He decided to sell the shell home mortgages owned by Markham Homes, Inc., to savings and loan associations. Accordingly he sold the veterinary practice in South Dakota and moved to Pryor, Okla., where he and his brother-in-law established a lumber yard. In searching for outlets for shell home mortgages, he was told about Peoples Loan & Investment Company (PL&I) of Fort Smith, Arkansas, which had bought mortgages from American Home Builders, Inc. (AHB), likewise engaged in the construction of shell homes. In the spring of 1965 he contacted the witness Austin Gatlin at his home in Mountainburg, Ark. He discovered that Gatlin had purchased the controlling stock of PL&I in 1961 and had operated it through July 1, 1964, when he sold his stock to Sexton, Hall and Smith in 1964 for $500,000 cash, and that Sexton had become President of PL&I. Because of

the experience that Gatlin had had in the organization and operation of finance mortgage companies, he was employed by Markham to set up a finance or mortgage company. At that time Markham decided that the company would be established at Springdale, Ark.

In July or early August 1965, Markham and Willis called on Sexton at the office of PL&I, and advised Sexton that they were in the shell home business in Oklahoma and were unable to secure financing for houses that they could sell. They wanted to discuss with Sexton a program for financing their shell homes. Subsequent to that conversation, Sexton learned from Gatlin that he was going to set up a finance company for Markham and that they wanted copies of the form file. Further conversations were held with Sexton which led to a proposal by Sexton to sell AHB exclusive of PL&I, the controlling stock of which was owned by AHB. Later offers to sell AHB, together with the controlling stock of PL&I, were made, and Markham decided to purchase AHB. The method or procedure to follow to complete the purchase was fully considered by Markham and Gatlin, and they decided to organize a new corporation, Investors Thrift Corporation, and to purchase all of the capital stock of AHB which also owned PL&I. Markham had connections in South Dakota with affluent persons who he thought would readily subscribe for the stock of Investors Thrift. Acting upon this assumption, Gatlin proceeded in accordance with his employment by Markham to organize the new corporation. The total amount invested in Investors Thrift by defendants and others not parties herein is $947,300.00, which includes the amounts borrowed from plaintiff bank.

The original incorporators of Investors Thrift met at the home of Gatlin on August 10, 1965. The minutes of that meeting show that the defendants H. T. Ringling, Robert Carter and Andy D. DeHaan were present in per-

son, and that the defendant Ilo Vanderboom and one R. S. Miskimins were present by their proxy, M. W. Markham. (Miskimins is not a defendant in the instant action, but is a defendant in an action by plaintiff in the Circuit Court of Sebastian County, Ark. In that suit Miskimins has made the same admissions and filed the same counterclaims as the defendants here.) The minutes of the first meeting of Investors Thrift show that at that time Ringling and Carter each subscribed for 60,000 shares; DeHaan for 150,000 shares; Miskimins for 100,000 shares; and Vanderboom for 40,000 shares, in the new corporation. Markham then began to finalize the purchase of AHB which, as heretofore stated, controlled PL&I. A proposed purchase agreement was drafted dated Sept. 2, 1965, but it was not executed, and another contract dated Sept. 9, 1965, was drafted and submitted by Markham to Sexton, who, after redrafting several pages, agreed to it, and the contract was signed by Sexton, Hall and Smith as sellers and by Markham for Investors Thrift as buyer. A true copy of the contract is attached to the affidavit of Sexton which is Exhibit 2 to the motion of plaintiff.

By the terms of the contract Sexton, Hall and Smith agreed to sell Investors Thrift all their interest and ownership and control of certain companies specifically named in paragraph 1 of the contract, and granted to Investors an option to purchase the same upon the terms and conditions set forth in the contract. The consideration for the option recited in the contract as $150,000 was paid to the sellers. The amount paid was actually only $50,000, as $100,000 was refunded to Markham to be divided between Markham and Gatlin in the form of stock in Investors. The option and sale agreement gave Investors from Sept. 9, 1965, until January 10, 1966, to determine if Investors desired to consummate the sale by paying the balance of the contract price of $857,500.00, of which $157,000 was

paid to Sexton, Hall and Smith, and a balance of $700,000 to Texas Capital Corporation to pay the sellers' debt to that company.

The contract further provided that as of the date of the contract Markham should become General Manager of AHB, which he did and has remained so from that date.

> "The parties specifically agree that until January 10, 1966, or until the exercise of said option, whichever is sooner, Smith shall continue in his capacity as President of AHB, and Sexton shall continue in his capacity as Chairman of the Board and General Manager of PL&I; provided that Austin Gatlin shall be and act as consultant for PL&I, commencing September 15, 1965, at a monthly salary of One Thousand Five Hundred and No/100 Dollars ($1,500.00), and Sexton shall perform no act in said capacity without Gatlin's approval; and M. W. Markham shall perform the duties of General Manager of AHB, effective on the execution hereof."

The option was exercised on November 2, 1965, or 69 days sooner than the time granted in the contract. On pages 6 and 7 of the affidavit of Markham, the following statement appears:

> "On September 7, 1965, Jim Tuttle, a certified public accountant, with Glenn Davis and Company of Muskogee, Oklahoma, made a preliminary survey of American Home Builders, Inc., and Peoples Loan and Investment Company, at the request of Markham Homes, Inc. As a result of his survey, he advised me that with their available personnel, it would take at least six (6) months to complete an audit of Peoples Loan and Investment Company and American Home Builders, Inc., and that a minimum of three (3) months would be required regardless of the number of personnel employed to do the work.

"Betsy Willis, my sister and bookkeeper for Markham Homes, Inc., continued to advise Jimmy Willis, her husband, and me that we should have an audit made before closing the transaction."

The State Bank Department had a continuous record of examinations or audits of PL&I, and these records were in the files of PL&I and AHB. Gatlin advised Markham to have the records carefully checked and verified.

At the request of Markham, Sexton obtained a letter from the State Bank Department. The letter, dated October 19, 1965, signed by the State Bank Commissioner, appears in the record and states:

"This letter is to certify the Peoples Loan & Investment Company has a certificate of authority under Act III to operate an industrial loan institution supervised by the State Bank Department.

"At the present time, there is no assessment due the Department which has not been paid. The Company is conforming to the Act under which it is operated, including rules and regulations."

Also, another letter of the same date was written by Clint Jones, Securities Commissioner, in which he stated:

"This is to advise that our records disclose Peoples Loan and Investment Company, Fort Smith, Arkansas, is registered as an industrial loan institution under Act 111 of 1941. This authority is currently in effect, and the corporation is operating under this authority issued by the State Bank Department of the State of Arkansas.

"They filed regularly semi-annual reports with our Department and, as far as our records disclose, they are operating in strict compliance with the abovementioned Act under which they are authorized in the State of Arkansas."

It is undisputed that Ilo Vanderboom, one of the defendants, spent several weeks in Fort Smith examining the books and records of both corporations, and did not discover any errors or omissions. Markham says in his affidavit that Vanderboom "was not looking for any."

For reasons best known to the defendants, Investors Syndicate exercised its option by paying to Sexton, Hall and Smith the $157,000 as heretofore stated on or before November 2, 1965, instead of waiting until January 10, 1966.

Markham and the defendants took no action to obtain an independent audit of the accounts of the two corporations until they had been in full possession and operation approximately 19 months.

Sometime subsequent to November 2, 1965, the date defendants exercised their option to purchase AHB, Markham, in conjunction with Gatlin, decided that additional funds or capital were required. In order to raise a portion of the additional funds, the defendants renewed their notes, paid interest, executed new notes, and asked for and were granted extensions.

The actions and dates thereof of the defendants relative to the notes upon which plaintiff bases its claims are admitted by the defendants, and are as follows:

In No. 2103, Vanderboom obtained his first loan of $15,000 from plaintiff on October 29, 1965, and increased it to $25,000 on December 31, 1965. He made partial payments of principal of $2,500 on February 8, 1966, and on June 5, 1967, of $1,944.46, and also on June 5, 1967, signed the last agreement to extend the note to September 1, 1967, and paid interest to June 5, 1967;

In No. 2104, Dellaan Livestock & Grain Farms, Inc., obtained its first loan of $90,000 from plaintiff on October 29, 1965, and increased it to $105,000 on January 10, 1966.

This defendant made a partial payment of principal of $26,250.00 on June 27, 1966, and of $8,750.00 on June 5, 1967;

In No. 2105, Ringling obtained his first loan of $10,000 from plaintiff on October 29, 1965, and increased it to $50,000 on December 31, 1965. He made a partial payment of principal of $5,555.56 on May 30, 1967, and on June 5, 1967, executed an extension agreement, extending maturity of the note to September 1, 1967;

In No. 2106, Nachtigal obtained his loan of $50,000 on February 29, 1966, after being flown to Fort Smith by Markham, and made a partial payment of principal of $4,166.66 on June 13, 1967, when he also executed an extension agreement, extending the maturity to September 1, 1967;

In No. 2107, Carter obtained his first loan of $25,000 from plaintiff on October 29, 1965, and increased it by $15,000 on January 10, 1966, and on February 9, 1966, consolidated the loan into one note for $40,000. He made partial payments of principal of $5,000 on May 2, 1966, and of $2,777.78 on June 5, 1967, when he also signed an extension agreement, extending maturity to September 1, 1967.

Notice to Bank of the Alleged Fraud

The court is convinced that the record before it establishes that there is no genuine issue as to any material fact in the controversy between the plaintiff bank and the defendants. Therefore, the question arises as to whether the plaintiff under the facts is entitled to a judgment as a matter of law.

Most of the material facts have hereinbefore been set forth, but in the consideration of the question as to whether plaintiff is entitled to a judgment as a matter of law, other undisputed facts will be mentioned.

It is not disputed that Hall, Sexton and Smith owned the controlling capital stock of AHB and PL&I, subject to an indebtedness owed to the Texas Capital Corporation. Hall and Sexton have testified by way of deposition, and each of them has submitted an affidavit. Smith has not appeared since he is presently in Vietnam.

Sexton had no connection with the bank other than as a depositor and possibly a creditor. Hall was a vice president of the bank, and the defendants contend that he had full and complete knowledge of the financial condition of the two corporations; that he concealed the true financial condition of the corporations and misrepresented to them and to their agent the facts relative to the financial condition of said corporations; that such knowledge possessed by Hall was imputed to the bank and the bank became liable to them for the alleged fraud and concealment of Hall; and that the notes sued on should be cancelled.

In considering these contentions, it may be assumed that Hall and Sexton did not disclose all of the facts known by them as to the real financial condition of the two corporations, but there is no proof that the bank had knowledge of the alleged concealed facts, if any, or knew of any misrepresentations, or that a fraud upon the defendants was about to be committed by Hall and Sexton.

It may be inferred from all the facts that once the money was available, Markham decided to begin operations and dispose of the mortgages not only of AHB but also of Markham Homes, Inc. The question of how Markham managed the business is not material to the question herein before the court.

It is undisputed that the defendants applied to Mr. Smoot for the loans. He required financial statements from each of the defendants, and was advised by them that they intended to use the money for the purchase of the capital stock of Investors Thrift Corporation, which

had been organized or would be organized to purchase the capital stock of AHB and PL&I. In response to interrogatories submitted to Mr. Smoot, he stated that he had had some conversations with some of the defendants in person or by telephone. Interrogatories 15 and 16 inquired of Mr. Smoot as to the financial condition of AHB and PL&I. Mr. Smoot responded by stating that although the term "financial condition" is a matter of opinion, as far as he knew both corporations were considered to be good, but that he could not answer as to the knowledge of other officers of the bank; that he had no knowledge of Hall's interest, if any, in the loans; that Hall, in a conversation with him relative to the application of defendants for the loans, stated in substance that because of his personal interest he could not and would not participate in the making of these loans; that the matter was up to him to use his own judgment whether he wanted to make the loans or not. "My recollection is that at the time that this was discussed, Mr. Hall used these words, 'I couldn't care less whether the loans are made or not,' or words very similar."

The general rule is well stated in 10 Am. Jur. 2d, Banks, § 163, at page 153, as follows:

> "The broad general rule that knowledge acquired by, or notice communicated to, an officer or agent of a corporation while acting in his official capacity or within the scope of his duties will be imputed to the corporation, is fully applicable to banking corporations. Hence, subject to certain well-recognized limitations and exceptions, where a director or an officer has knowledge of material facts respecting a proposed transaction, which his relations to it as representing the bank have given him, it becomes his official duty to communicate that knowledge to the bank, and he will be presumed to have done so and his knowledge will be imputed to the bank * * *."

With respect to certain types of knowledge, specifically knowledge of a fraudulent scheme, the authors in § 167 at page 155 state:

> "It is a well-settled exception to the general rule regarding the imputation to the bank of the knowledge of its officer or agent that when the officer or agent of a bank is acting in a transaction in which he is personally or adversely interested, either in the legitimate transaction of his own business at the bank of which he is an officer or agent, or when engaged in the perpetration of an independent fraudulent transaction which it would be to his interest to conceal, the bank is not chargeable with his uncommunicated knowledge of facts derogatory to such interest or to the title of property which is the subject of the transaction, unless such officer or agent is the sole representative of the bank. This exception—namely, where the officer or agent of a bank is acting for his own interest, either adversely or fraudulently—has been applied where the officer interested was the president, the cashier, the president and cashier, a vice president, or a director of the bank, and it has also been held to apply to a promoter of the bank. Accordingly, when an officer or director of a bank offers a note for discount, the bank is not charged with his knowledge affecting the validity or effectiveness of the note. A bank is not charged with notice of the falsity of representations made by its officers or employees to induce a third person to loan money to a corporation in which they were interested, although part of the loan was used to reduce the corporation's debt to the bank. Likewise, a bank, in accepting its president's check on account of a previous overdraft made by him, is not chargeable with notices that he is insolvent and indebted to the bank on which the check is drawn, it being to the president's interest to conceal

such facts from the bank. Indeed, the fact that the president of a bank owns its entire capital stock and manages its business does not charge the bank with notice of an attempted appropriation of bank assets by such president to his individual debts. The knowledge of a bank vice president in wrongfully pledging bonds of a customer on a speculative margin account of his own is not imputable to the bank. A bank cashier's knowledge of his own unlawful acts is not imputed to the bank or its officers. The view has also been taken that although when an officer of a bank misappropriates the funds of a depositor and converts the money to his own use the bank is not chargeable with his knowledge, yet if the money misappropriated is received by the bank into its general funds, the bank is chargeable with the knowledge as to how that money was obtained; otherwise, those dealing with the bank would be remediless against it in case of fraud or misappropriation on the part of an officer."

In §§ 169 and 170, 10 Am. Jur. 2d, Banks, there is a rather full discussion of whether knowledge acquired by a bank officer, in his private capacity and not while acting for or on behalf of the bank, will not be imputed to the bank. In § 170 it is stated:

"Where a person is a director or other officer of a bank and also an officer of another corporation, knowledge acquired by him in the latter capacity will not, as a general rule, be imputed to the bank. • • • Where a corporation and a bank have an officer in common and the former is obtaining a loan from the latter, the knowledge of the common officer of a lien on security given for the loan or of his intent to misappropriate the proceeds of the loan will not be imputed to the bank of which he also is a director or officer."

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In Monroe v. Harriman (2d Cir. 1936), 85 F. 2d 493, the court explained how an officer involved was a sole representative of the bank. Speaking at page 496, the court stated:

> "In the case at bar, however, Harriman's domination was exerted to affect the action of the bank with respect to the particular transaction. His will alone caused the making of the loan and the acceptance of the collateral."

Without doubt, Edward H. Smoot, President of the bank, represented the plaintiff in the making of the loans. No doubt Hall knew that the defendants had applied for the loans and expected to benefit therefrom, but it is equally certain that he did not reveal the alleged fraudulent scheme, if any, to the bank or to Mr. Smoot. The bank acted in good faith in making the loans. Thus, even if there was a fraud committed by Hall and his associates, the knowledge of Hall and his associates cannot be imputed to the plaintiff bank.

In Great American Indemnity Co. v. First National Bank of Holdenville (10 Cir. 1938), 100 F. 2d 763, the court cited with approval and quoted at pp. 756-66 from Aetna v. Local Building & Loan Ass'n, 162 Okl. 141, 19 F. 2d 612, as follows:

> "'In this connection it is the general rule of law that the knowledge of an agent is imputed to the principal. The reason for this rule, recognized by most courts, is that it is presumed the agent will communicate his information to the principal. This reason has been criticized by some eminent authorities who urge that the real reason is based upon broader ground of policy and expediency to safeguard the affairs of business and society. Pomeroy on Equity Jurisprudence, 94th Ed., Vol. 2, par. 676.

" 'Regardless of the reason for the rule, there is universally recognized exception; namely, that the knowledge of the agent will not be imputed to the principal when such knowledge concerns a transaction in which the agent is "engaged in the commission of an independent fraudulent act on his own account and the facts to be imputed relate to this fraudulent act." 21 R. C. L., page 844.

" 'The reason for this exception recognized by the authorities which place the reason for the rule upon the basis of presumed communication is that where the agent is committing a fraud it would be contrary to common sense to presume that he would communicate the facts to his principal. The reason for the exception, recognized by the authorities who place the rule upon the ground of expediency and policy, is that when engaged in the perpetration of a fraud, the agent is not really acting for his principal, but is really acting for himself entirely outside the scope of agency. * * * The plaintiff * * * states that there is a qualification to the exception, or exception to the exception, the gist of which is that where the agent, though engaged in perpetrating an independent fraudulent act on his own account, is the only representative of the principal, his knowledge is imputed to the principal, falling within the general rule imputing knowledge to the principal. * * * Campbell was not the only agent of the defendant in the transactions. * * * The checks mailed to Oklahoma City were received and placed in the process of clearance in Oklahoma City by other agents of the defendant company. * * * Therefore, it seems to us obvious that with the proper application of the rule the qualification mentioned above has no bearing on this case, for the reason that in the receipt of the money by the defendant company the agent Campbell was not the

only agent of the defendant connected with the transactions. We therefore hold in this connection that the knowledge of the agent Campbell was not imputed to the defendant.' "

See, Schram v. Burt (6 Cir. 1940), 111 F. 2d 557, 564; Anderson v. General American Life Ins. Co. (6 Cir. 1944), 141 F. 2d 898, 907-9.

In American National Bank v. Miller (1913), 229 U. S. 517, 33 S. Ct. 883, 57 L. Ed. 1310, the court held that knowledge of fraud of an officer will not be imputed from even the controlling officer, unless it was his duty to disclose same and concealing the information would not be to his personal benefit.

Mr. Justice Lamar, in writing for the court, beginning at page 521 of 229 U. S., said:

"This presents another phase of the oft-recurring question as to when and how far notice to an agent is notice to his principal. In view of the many decisions on the subject it is unnecessary to do more than to apply them to the facts of this case. If Plant, within the scope of his office, had knowledge of a fact which it was his duty to declare and not to his interest to conceal, then his knowledge is to be treated as that of the bank. For he is then presumed to have done what he ought to have done and to have actually given the information to his principal.

"But if the fact of his own insolvency and of his personal indebtedness of the Nashville Bank were matters which it was to his interest to conceal, the law does not by a fiction charge the Macon Bank, of which he was President, with notice of facts which the agent not only did not disclose, but which he was interested in concealing.

"Plant was a private banker in Macon and as such indebted to the First National Bank of Macon, of

which he was President and so far dominated as to compel it to take care of the large balances against him in the clearing house, frequently more than 50 per cent. of the $200,000 capital of the Macon Bank. On May 13th Plant was indebted to the Macon Bank on this account between $75,000 and $100,000. A National Bank Examiner was in the city and it was expected that he would examine the books of the Macon Bank within a few days, when this illegal overdraft by the President would appear. Rev. Stat., § 5200; Evans v. United States, 153 U. S. 584. Plant thereupon gave the Bank checks and commercial paper to pay the balance. It was to his personal interest to conceal any fact which would prevent the Macon Bank from receiving paper in satisfaction of a debt which had been unlawfully contracted by reason of his official position. An element of that interest was that he should conceal not only the fact of his insolvency but the fact of his indebtedness to the Nashville Bank, lest the Macon Bank should thereby refuse to take the $3,000 check at its face value. Without, therefore, inquiring as to what would have been the duty of the Macon Bank had it known of Plant's insolvency and indebtedness on the $50,000 drafts, we hold that as it had no such knowledge in fact it was not charged with such knowledge in law."

Since the jurisdiction of the court depends upon diversity and the amount involved, the substantive law of Arkansas is controlling.

In Foch v. Taylor (1932), 186 Ark. 700, 55 S. W. 2d 74, in an action on a note defended on the grounds that the loan was made to purchase stock in a corporation of which the bank officials were officers, the court, in holding for the bank on the note, said at page 701 of 186 Ark.:

"He [appellant] insists also that the court erred in not holding the note was executed without con-

sideration and void upon the assurance of the officers of the bank that he would never have to pay it. He admits, however, that he executed the note and the money was loaned him by the bank with which to purchase stock of an ancillary or auxiliary corporation, of which the bank officials were officers and who assured him that he would never have to pay the note, and that the dividends from the stock of the new company would take care of the loan. The stock was issued to him upon his purchase thereof, and he continued to renew the old note and pay the interest thereon until the execution of the note sued on herein, the last renewal of the note given. He borrowed the money, however, and admitted that he had never repaid it, and there could be no failure of consideration so far as the loan of the money upon the note discounted was concerned since he got the value of the money for which the note was executed. The fact that the stock purchased with the money he received on the note finally proved to be without value did not constitute failure of consideration for the note executed for the loan; and, even if it were true, which is not shown, that the bank officials made fraudulent representations to him to induce him to take stock in the ancillary company and loaned him the bank's money for that purpose, he would still be bound to the payment of the money loaned upon this note, since the bank officers had no authority, and could have none, to lend the bank's money to enable persons, who desire to do so, to buy stock in the ancillary corporation, of which they were also officials. This could not be done even though they had attempted to guarantee, which was not done, sufficient returns upon the stock purchased to take care of the repayment of the money loaned. Clements v. Citizens' Bank of Booneville, 177 Ark. 1085, 9 S. W. (2d) 569."

Thus, even if Hall concealed material facts from the defendants in that Hall, Sexton and Smith had formed a fraudulent scheme to sell AHB and PL&I, under the general law and law of Arkansas, the knowledge of this scheme was not imputed to the plaintiff bank, and such concealment is not a defense to the notes executed by defendants.

The Charge That Bank Aided and Abetted Hall, Sexton and Smith in Committing a Fraud

The defendants alleged that the plaintiff bank had violated § 10(b) of the 1934 Act, 15 U. S. C. A., § 78j(b), and Rule 10b-5, Title 17, § 240.10b-5, p. 334, Code of Federal Regulations.

Sec. 78j, supra, provides:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> * * * * * * * *
>
> "(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule 10b-5 was promulgated to aid in the enforcement of § 78j, supra. The first paragraph of the rule is the same as the first paragraph of § 78j. Subparagraphs (a), (b) and (c) of the rule provide:

"(a) To employ any device, scheme, or artifice to defraud,

"(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

"(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

"in connection with the purchase or sale of any security."

Sec. 17(a) of the Securities Act of 1933, 15 U. S. C., § 77q(a) provides in part:

"It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

"(1) to employ any device, scheme, or artifice to defraud."

The short answer to defendants' contention is that the plaintiff bank did not call or offer to sell any security of any kind to the defendants. The defendants approached the bank and expressed a desire to borrow money which they, of their own volition, intended to use in the purchase of the capital stock of a corporation, Investors Thrift Corporation, organized by themselves. When the proceeds of the notes were delivered to the defendants, the money belonged to them and they could use it in any manner. The fact that they purchased the stock of and from their own corporation with the proceeds of the notes is not sufficient to hold the plaintiff bank liable under the undisputed facts as found and commented upon by the court.

There is no testimony to show that the plaintiff bank used the mails or any other instrument of interstate commerce in loaning this money.

In Rosen v. Albern Color Research, Inc. (E. D. Pa. 1963), 218 F. Supp. 472, the court stated at page 476:

> "So far as we perceive, Congress did not undertake to regulate those transactions effected by direct person-to-person contact and negotiation. We are not here concerned with abstract considerations of power, but with actual manifestations of congressional purpose and intent."

The Court of Appeals for the Eighth Circuit in Myzel v. Fields (1967), 386 F. 2d 718, criticized the discussion in the Rosen case of the use of the mails or other facility of interstate commerce, but did not criticize the above quoted statement.

In Little v. United States (8 Cir. 1964), 331 F. 2d 287, the court at page 292 said:

> "The 'evil at which the Securities Act is directed is the fraud in the **sale** of securities.' United States v. Cashin, 281 F. 2d 669, 674 (2 Cir. 1960). That being the congressional purpose and intendment to be covered by the 'Securities Act of 1933,' *a fortiori*, the law of 'sales' and impact of fraud in relation to 'sales,' rather than the principles of 'banks and banking' or 'bills and notes,' should be considered in making practical application of that Act to a given set of facts. In other words, it is our opinion that a scheme to defraud, in relation to a sale of securities, and the use of the mails in consummation thereof, is the gist of the crime denounced by the Congress in Section 17(a) of the Securities Act of 1933, supra. Under that Act, the use of the mails need not be central to the scheme to defraud."

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The uncontradicted facts show that the only thing the bank did was to loan money to the defendants, which they used to pay for the capital stock of their own corporation, but the bank had no notice whatsoever of any fraudulent scheme which brought into existence the issuer and seller of the stock, Investors Thrift Corporation, or the actions of Investors Thrift in purchasing AHB and PL&I. Therefore, the contention of the defendants that the plaintiff cannot recover on the notes because it loaned the defendants the money with which to buy capital stock in their own corporation is without merit.

The Contention of Waiver and Estoppel Asserted by Plaintiff

In its reply to defendants' amended counterclaim, plaintiff specifically pleads that the defendants have waived the defenses and right of action sought to be asserted and are now estopped from raising such defenses by their admission of making partial payments of principal, paying interest, and obtaining extensions of the notes executed by them.

Even assuming, and the court does not, that the defendants did not become fully aware of the alleged misrepresentations until the fall of 1967, it is clear that any knowledge obtained by the defendants' agent, Markham, is imputed to them, whether or not he informed them thereof. Bay Aviation Services Co. v. Southland Aviation, Inc. (W. D. Ark. 1962), 211 F. Supp. 125; M. F. A. Mutual Ins. Co. (W. D. Ark. 1958), 169 F. Supp. 633; 3 Am. Jur. 2d, Agency, § 273. It is equally clear that any knowledge available to Markham through the exercise of reasonable diligence is also imputed to defendants. Trinity Royalty Co. v. Riggins (1940), 199 Ark. 939, 136 S. W. 2d 473; 3 Am. Jur. 2d, Agency, § 277; 3 C. J. S., Agency, §§ 262-263.

Markham became General Manager of AHB on September 9, 1965, with full access to its records. By his own admission, he was advised by Gatlin within a few days thereafter that Sexton might be robbing the company. Gatlin also advised Markham to make a thorough investigation of the assets and liabilities of PL&I and then determine whether or not he wanted to buy it. Huey Smith indicated to Markham about the same time that Sexton should be removed from management of PL&I. On September 7, 1965, Markham was advised by a certified public accountant that an audit of AHB and PL&I could be completed in a minimum of three months if sufficient accounting personnel were employed. Markham stated in his affidavit that he continued to be advised by his sister, who was the bookkeeper for Markham Homes, Inc., that an audit should be made before closing the transaction. Notwithstanding these warnings, Markham, on behalf of the defendants, exercised the option on November 2, 1965, over two months before it would have expired, thereby gaining control over AHB and PL&I. All of the defendants except Nachtigal executed notes with the plaintiff on October 29, 1965, prior to the execution of the option. Early in 1966, they were informed by Markham that AHB was having financial difficulty, yet defendants Vanderboom and Ringling increased their borrowing on December 31, 1965, and defendants DeHaan and Carter obtained increases on January 10, 1966. Nachtigal obtained his loan of $50,000 on February 29, 1966, after being flown to Fort Smith by Markham. In the following months, all of the defendants made partial payments on the notes, as heretofore set forth. No audit of AHB and PL&I was requested by the defendants until May of 1967, nineteen months after the option had been exercised giving defendants full access to the records. In May of 1967, Mr. Smoot and Leslie Greathouse, representing the plaintiff, went to South Dakota in order to determine what the borrowers proposed to do about a plan of payment. During the

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meeting Markham told the defendants that Jim Hall had misrepresented things in reference to PL&I and Investors Thrift, that he, Markham, had been misled by Gatlin, and that he could not say what the stock (Investors Thrift) was then worth. Notwithstanding the above, all of the defendants thereafter made partial payments of the notes and signed extension agreements. There is nothing in the record indicating an intention at any time by the defendants to reserve any defenses or that they were induced to execute the notes by any fraudulent representations by any one. No claim by any of them was asserted until the fall of 1967, two years after they assumed control of the corporations.

Under the substantive law of Arkansas the general rule is that the giving of a renewal note or making partial payments with knowledge at the time of false representations on the part of the payee operates as a waiver of that defense, and the maker is thereby estopped from pleading such defenses in an action on the renewal note. Trent v. Johnson (1932), 185 Ark. 288, 47 S. W. 2d 12 (partial payments); Harrington v. Citizens' Investment & Security Co. (1923), 160 Ark. 320, 245 S. W. 831 (renewal); Sebastian County Bank v. Gann (1915), 121 Ark. 115, 180 S. W. 754 (renewal); Haglin v. Friedman (1915), 118 Ark. 465, 177 S. W. 429 (renewal); Stewart v. Simon (1914), 111 Ark. 358, 163 S. W. 1135 (renewal); 11 Am. Jur. 2d, Bills and Notes, § 391. In Anderson v. Tway (6 Cir. 1944), 143 F. 2d 95, the court at page 102 made the following statement:

> "It is the law that one who renews or makes payment on a note after knowledge of defenses that may be interposed to its collection, waives them. E. H. Taylor, Jr. & Sons v. First Nat. Bank, 6 Cir., 212 F. 898; Fitzpatrick v. Flannagan, 106 U. S. 648, 1 S. Ct. 369, 27 L. Ed. 211; and this extends to payment of interest. Rosenbloom v. Kaplan, 273 Mass. 411, 173

N. E. 522; Brummett v. McGowan, 165 Okl. 59, 24 P. 2d 980. It is in reliance upon this rule that the receiver urges the fraud to have been waived by Tway when he made his several renewals of the note and his several payments of interest thereon."

Each defendant in his affidavit stated that he had no intention of waiving any defense by the payment of interest, partial payment of principal, and by obtaining extensions of time in which to pay. One cannot, however, prevent a waiver by a mental reservation to the contrary of an intent to waive, where his acts clearly indicate such intent. Re Schulte Retail Stores Corp., 22 F. Supp. 612 (S. D. N. Y. 1937), aff'd Re Walker (2 Cir. 1937), 93 F. 2d 281; 28 Am. Jur. 2d, Estoppel and Waiver, § 158.

The plaintiff did not in anywise solicit the defendants to execute the notes. The bank did know that the defendants obtained the loans for the purpose of subscribing for the capital stock of Investors Thrift, which was their own creature. There may have been some conversation between some of the defendants and Mr. Smoot, the President of the bank, as to what use the defendants intended to make of the proceeds of the loan, but there is no proof that Mr. Smoot made any representations as to the financial condition of the two corporations. The court has already referred to interrogatories submitted to Mr. Smoot as to his opinion of the financial condition of AHB and PL&I. Interrogatory No. 15 is as follows: "What was the financial condition of American Home Builders as known to the officers of the City National Bank at the time of making the loan or loans sued on herein?" Interrogatory No. 16 makes the same inquiry as to the condition of PL&I. Both interrogatories were answered as follows: "Although the term 'financial condition' is a matter of opinion, as far as the undersigned knew, it was considered to be good. I cannot answer for the other officers."

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Evidently the defendants are persons who have been financially successful. Defendants claim they invested a total of $947,300.00, which includes the amounts borrowed from the bank. This would indicate that they used their own judgment in their financial deals, and it is difficult for the court to understand why men of that caliber and experience would blindly follow the judgment of their agent whose judgment they knew was not based upon an audit or an examination of the records of the corporations. No doubt the picture painted by Markham was alluring, and they simply took a chance. The fact that they are dissatisfied is not in itself proof that there was any misrepresentation. Certainly no fraudulent representations were made by the bank, and the bank did not aid or abet in any fraudulent statements, if in fact any were made by anyone. In any event, the inescapable fact is that the defendants' agent, Markham, either knew or by the exercise of reasonable diligence should have known the true condition of AHB and PL&I at the times the partial payments were made and the extension agreements were executed, and such knowledge is imputed to the defendants. They must be held to have waived any fraud in the transaction.

Is the Bank a Holder of the Notes in Due Course?

The plaintiff, in its reply to the amended counterclaims of defendants, alleged in paragraph 18 that "it is the holder in due course of the note described in the complaint, and as such holds the same free from the claims sought to be asserted by defendants in the amended counterclaim."

The Uniform Commercial Code became effective in Arkansas January 1, 1962, and is incorporated in Ark. Stat. Ann., §§ 85-1-101 to 85-9-507.

Section 85-3-302 states:

"Holder in Due Course. (1) a holder in due course is a holder who takes the instrument

(a) for value; and

(b) in good faith; and

(c) without notice that it is overdue or has been dishonored or of any defense against or claim to it on the part of any person."

Section 85-3-305 states:

"Rights of a holder in due course.—To the extent that a holder is a holder in due course he takes the instrument free from

(1) all claims to it on the part of any person; and

(2) all defenses of any party to the instrument with whom the holder has not dealt except

(a) infancy, to the extent that it is a defense to a simple contract; and

(b) such other incapacity, or duress, or illegality of the transaction, as renders the obligation of the party a nullity; and

(c) such misrepresentation as had induced the party to sign the instrument with neither knowledge nor reasonable opportunity to obtain knowledge of its character or its essential terms; and

(d) discharge in insolvency proceedings; and

(e) any other discharge of which the holder has notice when he takes the instrument."

Obviously from the undisputed facts, the bank took the notes in good faith and is a holder in due course.

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Each defendant admits that he obtained the money in accordance with the provisions of the note, and under the undisputed facts none of the defendants was under such incapacity or duress as would render the note or notes a nullity. There was no illegality of the transaction between the bank and the individual borrowers. There were no misrepresentations by the bank which induced any of the defendants to execute his note "with neither knowledge nor reasonable opportunity to obtain knowledge of its character or its essential terms." Only fraud as to nature of instrument itself is a defense to action by a holder in due course, and even if Hall had made false statements or concealed facts relative to the sale of the corporations to Investors Thrift, the same is not a defense to the notes.

The motion of plaintiff for summary judgment should be granted, and judgment entered granting the motion and recovery by plaintiff against the individual defendant or defendants in each of the cases for the amount due, including interest as provided in the note or notes, together with costs.

Counsel for plaintiff will prepare and submit precedent in each case to counsel for defendants for approval as to form and amount.

This 27th day of September, 1968.

APPENDIX "D"

Civil Nos. 2103, 2104, 2105, 2106, 2107

United States District Court, Western District of Arkansas, Fort Smith Division

(Caption omitted)

Decided October 2, 1968 and October 15, 1968

Before: John E. Miller, United States Senior District Judge

Judgment Consolidated for Appendix

This cause, having been under advisement by the Court for determination of plaintiff's motion for a summary judgment granting the relief prayed in plaintiff's complaint and dismissing defendant's amended counterclaim against the plaintiff, and the Court having considered said motion, with the exhibits thereto, and defendant's response to said motion, with the exhibits thereto, and plaintiff's reply to such response and upon briefs of counsel, and the Court having, on September 27, 1968, rendered and filed its written opinion in this cause and in Civil Actions Nos. 2104, 2105, 2106 and 2107 in this Court, and for the reasons therein stated and being well and sufficiently advised, finds that plaintiff's motion for summary judgment granting the relief prayed in plaintiff's complaint and dismissing defendant's counterclaim, as amended, should be granted, and that plaintiff is entitled to the relief prayed in its complaint herein and to a dismissal of the defendant's counterclaim, as amended.

It Is Therefore Considered, Ordered and Adjudged by the Court that plaintiff's motion for summary judgment

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be and the same is hereby granted and that defendant be and he is hereby declared to be liable to plaintiff for payment of the note herein sued upon, according to its terms and as described in plaintiff's complaint; that the total amount of the principal unpaid balance thereof is the sum of: $20,554.00 in the case of Ilo Vanderboom, $70,000.00 in the case of DeHaan Livestock and Grain Farms, Inc. et al., $44,444.44 in the case of H. T. Ringling, $45,833.34 in the case of James Nachtigal, and $32,222.22 in the case of Robert Carter, with interest thereon from May 30, 1967, until paid, at the rate of six (6) per cent per annum, and that defendant be and he is hereby declared to be liable to plaintiff for that part of said note now past due and unpaid, in the total amount of: $12,222.22, with interest as aforesaid from May 30, 1967, until paid in the case of Ilo Vanderboom, $43,750.00, with interest as aforesaid from June 1, 1967, until paid in the case of DeHaan Livestock and Grain Farms, Inc., Andy D. DeHaan, Kenneth J. DeHaan, and Lyle R. DeHaan, $27,777.76, with interest as aforesaid from May 30, 1967, until paid in the case of H. T. Ringling, $20,833.34, with interest as aforesaid from May 30, 1967, until paid in the case of James Nachtigal and $18,888.88, with interest as aforesaid from May 30, 1967, until paid, in the case of Robert Carter, and for each remaining installment thereof when the same shall become due and payable, together with interest as provided therein, and that plaintiff is hereby declared to be entitled to judgment accordingly and to be entitled to a foreclosure of its pledge of collateral security as described in the complaint and to a sale thereof in the manner provided by law.

It Is Further Considered, Ordered and Adjudged by the Court that defendant shall take nothing on his counterclaim, as amended, and that the same be and it is hereby dismissed with prejudice.

To each of the aforesaid findings and judgment of the Court, the defendant excepts and saves his exceptions.

Entered this 2nd day of October, 1968.

Consolidated for Appendix
Motion to Amend Judgment to Conform to Opinion

For its motion, plaintiff states:

1. This Court has heretofore, on October 2, 1968, and pursuant to the Court's opinion heretofore filed herein, granted plaintiff's motion for summary judgment and entered its judgment that defendant is liable to plaintiff for payment of the note sued on by plaintiff in its complaint, and that defendant's counterclaim be dismissed.

2. Plaintiff states defendant is now justly indebted to plaintiff on said note in the sum of: $12,222.22, with interest thereon from May 30, 1967, in the case of Ilo Vanderboom, $43,750.00, with interest thereon from June 1, 1967, in the case of DeHaan Livestock and Grain Farms, Inc., et al., $27,777.76, with interest thereon from May 30, 1967, in the case of H. T. Ringling, $20,833.34, with interest thereon from May 30, 1967, in the case of James Nachtigal, and $18,888.88, with interest thereon from May 30, 1967, in the case of Robert Carter, at the rate of six (6) per cent per annum until paid, and said judgment should be amended to provide that plaintiff now recover said sum from defendant, for which execution may issue, and that plaintiff proceed to foreclose its pledge of collateral security for said note in accordance with the laws of Arkansas.

Wherefore, plaintiff prays such judgment be so amended and for such further relief to which plaintiff may be entitled.

Consolidated for Appendix

Order

On this 15th day of October, 1968, the court has considered the motion of plaintiff filed October 10, 1968, to amend judgment entered herein on October 2, 1968, to conform to the opinion of the court filed herein on September 27, 1968, and is of the opinion that the motion should be granted.

It Is, Therefore, Ordered and Adjudged that the motion be, and the same is, granted, and the judgment be, and the same is, amended by adding at the end of line ten on page two of the judgment the following:

That the plaintiff have and recover of and from the defendant the sum of: $12,222.22, with interest thereon from May 30, 1967, in the case of Ilo Vanderboom, $43,750.00, with interest thereon from June 1, 1967, in the case of DeHaan Livestock and Grain Farms, Inc., et al., $27,777.76, with interest thereon from May 30, 1967, in the case of H. T. Ringling, $20,833.34, with interest thereon from May 30, 1967, in the case of James Nachtigal, and $18,888.88, with interest thereon from May 30, 1967, in the case of Robert Carter, at the rate of 6 percent per annum until paid, for which execution or other process may issue, and that plaintiff may proceed to foreclose its pledge of collateral security for the payment of said note in accordance with the laws of the State of Arkansas; and that jurisdiction is retained for entry of judgment for further installments under the provisions of the note as they become due.

APPENDIX "E"

Nos. 19,550-19,551-19,552-19,553-19,554

United States Court of Appeals
For the Eighth Circuit

(Caption Omitted)

Decided March 20, 1970

Before: Mehaffy, Gibson and Heaney, Circuit Judges

Petition of appellants for re-hearing filed in the above cases, having been considered, it is now here ordered by this Court that the same be, and it is hereby, denied.